

CRANFIELD UNIVERSITY

Bixiu Zhang

An Analysis of China's Liberalisation Policy
with respect to International Air Transport

School of Engineering
Doctor of Philosophy

This thesis is submitted in partial fulfilment of the requirements
for the degree of Doctor of Philosophy
Academic Year: 2006 - 2010

Supervisor: Dr. George Williams
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ABSTRACT

International air transport is a commercial business by nature but carries a political significance. It has been regulated under the Chicago regime which requires the sovereignty governments to negotiate and determine how airlines engage in the transnational operations regardless of the market demand. Policy makers will have to take into account all factors, whether at international, domestic, institutional and individual levels, in determining to what extent the market should be liberalised so as to protect their national interest, optimise the opportunities for their industry and society as a whole, while at the same time promote competition and facilitate international trade.

Despite the vast research that has been done on the liberalisation of international air transport as well as China's aviation policy and its industry, little is known about the considerations of Chinese government when formulating its international air transport policy, e.g. what are the variables that have influenced the country's policy making process that leads to the policy per se. The focus of the existing literature fails to treat China's international air transport policy as a subject matter for an objective and comprehensive analysis, but rather takes the policy itself as an external stimulus that drives the radical changes of the industry. Consequently, China's policymaking process with respect to international air transport remains a black box and its international behaviour is considered unpredictable.

Applying the Micro-Macro Linkage Approach to three case studies, i.e. China-the US, China-the Netherlands and China-the UK markets, this research analyses China's liberalisation policy with respect to international air transport. By examining the data gathered through qualitative methods such as historical files and record, observations, and interviews with those who have participated in the process of policymaking and have been personally involved in bilateral air services negotiations, this research aims at identifying the factors that have had an impact on the country's policymaking process, establishing whether these factors are evolving over the years and determining how they are interacting with each other in leading to the policy outcome, hence, shedding light on the country's international trade policymaking and its international behaviour.

The research has revealed that China's international air transport policymaking is both a top-down and bottom-up process with industry regulator being the primary initiator, formulator and administrator of the industry-specific liberalisation policy. Its decision making process has become more transparent, plural, open for and subject to both external and internal influences at all levels. International environment including international conventions, laws and regulations have formed a framework within which the country has to operate to develop its overall national policy. Bilateral political and economic relationship has played a pivotal role in shaping the country's policy on that specific country-pair market. Domestic considerations such as national interest, benefits to the society, industry and consumers as a whole are the fundamental concerns in determining the policy scope, i.e. to what extent the market should be liberalised and the pace of such liberalisation. Stakeholders are increasingly proactive in its involvement in the policymaking process in an attempt to influence the policy makers to their own optimal benefits. Institutions and personal characteristics do shape individual policy makers' mindset and perceptions but only to the extent of affecting the negotiation outcome on the bilateral country-pair markets. These factors have been evolving over the years and are time- and circumstance-constrained, namely, some factors may function at one occasion at a certain time but not necessarily at another.

This research is a meaningful endeavour in attempting to understand China's policymaking process with respect to international air transport as an international trade in services, which has just received growing interest in both academia and industry practitioners in recent years. It will contribute to the knowledge of the study of China and the study of international air transport at large.

Keywords:

China, liberalisation, international air transport, trade in services, policymaking

ACKNOWLEDGEMENTS

In accomplishing this mission impossible, I have received enormous help and support from numerous people and organisations, without whom, this research will never reach completion. Those who have provided their support and encouragement are just too many to mention but I must highlight the following. First and foremost, I would like to extend my whole-hearted gratitude to my supervisor Dr. George Williams, who has been extremely patient in guiding me through the whole process of this undertaking. It is his knowledge, expertise and insight in international air transport that has inspired me significantly to pursue this research. Our discussions are not only very helpful in generating new ideas and shaping my thoughts but also very amusing. What is more, he has read through all my draft versions and corrected my grammatical errors! I am very grateful for Prof. Peter Morrell, who is also my supervisor and has provided me a lot of advice and information on the subject matter, which helped me to improve the writing. Furthermore, I must acknowledge the whole team of the Department of Air Transport in School of Engineering, who has given me magnificent support and assistance whenever there is a need. In particular, I thank Prof. Graham Braithwaite for offering me a bursary which enabled my continuation of the research; Dr. Keith Mason who has encouraged me to give presentations at international conferences; Dr. Frankie O’Cornell and Dr. Zheng Lei who have advised me on the data analysis, Mr. Andy Foster who has provided many contacts for my interviews, as well as the administrative team of the Department, Barbara, Hayley and Catriona, who have given me all the help I need during my research on campus.

My special thanks go to TIACA, which has partly sponsored me financially for the research. As a mature student, I am so privileged to receive the scholarship, which encouraged me to continue my pursuit for my career development.

I am deeply indebted to those persons who agreed to be interviewed. In particular I would like to extend my greatest gratitude to Mr. Li Jiangmin, Ms. Liang Nan and their team in CAAC who have provided me all the help I need in gathering the information and clarified all my queries with respect to the research. Their comprehensive knowledge in the subject matter, their vast experience in bilateral negotiations is so

impressive and inspiring that I wish I could have more opportunities to discuss with them and learn from them.

I would like to thank Mr. Alphons Daniels of the Ministry of Environment and Infrastructure of the Netherlands, Mr. Roeland van Klaveren of KLM, Mr. Wilco J.M. Sweijen of Amsterdam Airport, Mr. Bart Pouwels of Amsterdam Airport, Mr. Klaus Geil of the European Commission, Mr. Simon Knight of the Department for Transport of the UK, Mrs. Carol Cole of British Airways, Dr. Barry Humphreys of the former Virgin Atlantic, Mr. Genaro J. Pena of Houston Airport, Mr. Thomas S. Engles and Mr. Adam Packer of the US Department of State, Chief Representative of Northwest Airlines in China, former senior official of the US Embassy in Beijing, those senior managers of Chinese organisations including airlines and airports, and senior officials of local Chinese governments who prefer to remain anonymous.

These people have (either) been heavily involved in the formulation of the international air transport policies of their respective countries (or) and personally participated in the bilateral negotiations. The discussions I had with them have not only ensured the credibility and validity of the data gathered but also shed light on my understanding of how different system works and inspired me to explore further of the subject matter, which led to my findings and conclusions.

My special thanks must go to Mr. Wang Yuanzheng, Senior Officer in the Air Transport Bureau of ICAO. His willingness in sharing his expertise in the subject matter is most helpful and his professionalism is so impressive that I wish I could have more opportunities to learn from him.

I am very grateful to Mr. Marcus Archer of the Trade & Investment of the UK who has introduced me to the Department for Transport of the UK. I also thank Prof. Dr. J.G. de Wit of Airneth and Prof. Dr. Pablo M de Leon of the University of Leiden for their insight about the subject matter from academic perspective.

Last but not least, I must thank my brother and his family, and, especially, my parents, who throughout the years have been supporting me without any reservation. They have never ever hesitated to give me the “yes, go-ahead” whenever being away from my

teenager boy is required for the purpose of the research. They have offered me all their support, emotionally, physically, and financially, but only earned more grey hairs and deteriorating health conditions for return. I own every bit of my progress and achievement in my career development to them.

I devote this research to my family.

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LIST OF ABBREVIATIONS

AA	American Airlines (American)
ACC	Air China Cargo
ACI	Airport Council International
ACP	US-China Aviation Cooperation Program
ADS	Approved Destination Status—appears in us-china
AMM	ASEAN Ministerial Meeting
ANA	All Nippon Airways
AOC	Air Operator Certificate
APEC	Asia Pacific Economic Cooperation
ASA(s)	Air Services Agreement(s)
ASEAN	The Association of Southeast Asian Nations
ATAG	Air Transport Action Group
ATMB	Air Traffic Management Bureau of CAAC
BA	British Airway
BATA	British Air Transport Association
BCIA	Beijing Capital International Airport (Beijing Airport)
BMI	British Midlands Airways
BMI	Business Monitor International
BSB	Beijing Statistics Bureau
CA	Air China

CAA	UK Civil Aviation Authority
CAAC	Civil Aviation Administration of China
CAB	Civil Aviation Board
CAFTA	China-ASEAN Free Trade Area
CATA	China's Air Transport Association
CCA	China Cargo Airlines (China Cargo)
CCP	Chinese Communist Party
CEPA	Mainland and Hong Kong Closer Economic Partnership Arrangement
CNSB	China National Statistics Bureau
CNTA	China's National Tourism Administration
CO	Continental Airlines
COSCO	China Ocean Shipping Group Company
CRS	Computer Reservation Systems
CZ	China Southern Airlines
DfT	Department for Transport of the UK
DL	Delta Airlines (Delta),
DoC	Department of Commerce of the US
DoF	Department of Treasury of the US
DoS	Department of State of the US
DoT	Department of Transportation of the US
EC	European Commission

EC	European Community
ECJ	European Court of Justice
EEA	European Economic Area
EEB/TRA	Transportation Affairs division in the Bureau of Economic, Energy and Business Affairs
ENDT	the Executive Management Development Training
EU	European Union
FAA	Federal Aviation Administration
FAM	Fragmented Authoritarianism Model
FedEx	FedEx Corporation
FFP	Frequent Flyers Programme
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GBIA	Guangzhou New Baiyuan International Airport (Guangzhou Airport)
GDP	Gross Domestic Product
GE	General Electric Company
HKAA	Hong Kong Airport Authority
HU	China Hainan Airlines Company Limited (Hainan Airlines)
IASED	International Aviation, Safety and Environment Division in the UK DfT
IATA	International Air Transport Association
ICAO	International Civil Aviation Organisation

IMD	International Institute for Management Development
IMF	International Monetary Fund
JAL	Japan Airlines
JAS	Japan Airlines System
JCCT	the Joint Commission on Commerce and Trade
JEC	the Joint Economic Commission
KAL	Korean Air
KLM	KLM Royal Airlines
LCC	Low cost carriers
MFA	Ministry of Foreign Affairs of China
MFN	Most Favoured Nation
MoC	Ministry of Commerce of China
MoF	Ministry of Finance of China
MOFTEC	Ministry of Foreign Trade and Economic Cooperation of China
MoT	Ministry of Transportation of China
MOU	Memorandum of Understanding
MU	China Eastern Airlines (China Eastern)
NAFTA	Northeast Asia Free Trade Area
NDRC	National Development and Reform Commission
NPC	the National Planning Commission
NW	Northwest Orient Airlines (Northwest),

OAA	Open Aviation Area
OAN	Office of Aviation Negotiations
O&D	Origin and destination
OECD	the Organisation of Economic Co-operation and Development
OTP	Office of Transportation Policy
PRC	People's Republic of China
PRD	Pearl River Delta
RPK	Revenues Passenger Kilometres
RPM	revenue passenger miles
RTK	Revenues Tonne Kilometres
RTM	Revenue tonne Miles
SAA	Shanghai Airport Authority
SAR(s)	Special Administrative Regions
SASAC	State-Owned Assets Supervision and Administration Commission
SCO	Shanghai Cooperation Organisation
SDPC	State Development and Planning Commission
SED	Strategic Economic Dialogue
S&ED	the Strategic and Economic Dialogue
SEZ	Special Economic Zones
SOE	state-owned-enterprises
SPIA	Shanghai Pudong International Airport (Shanghai Pudong)

Southwest	Southwest Airlines
TMM	Transport Minister Meeting
TWA	Trans World Airlines
UA	United Airlines (United),
UN	the United Nations
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UPS	United Parcel Services
USTDA	the United States Trade and Development Agency
VG	Virgin Atlantic Airways (Virgin)
WTO	World Tourism Organisation
WTO	World Trade Organisation
YRD	Yangtze River Delta

Chapter 1 Introduction

1.1 International air transport as a trade in service

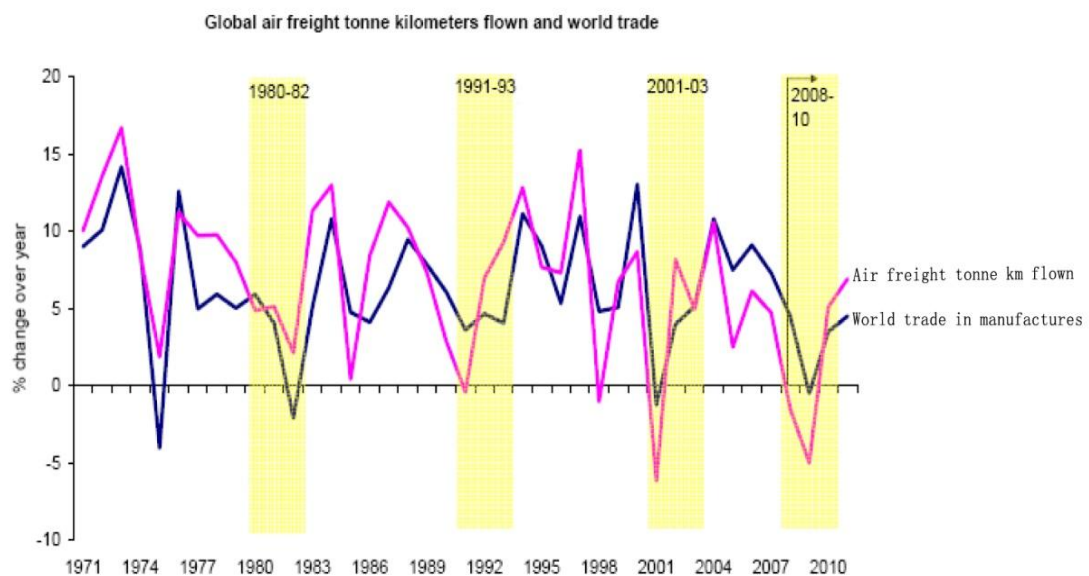
Trade is usually regarded as being beneficial because it allows a nation to specialise in the goods that it can produce relatively efficiently. This principle of “comparative advantage” is the core of trade theory and is the foundation of free trade (Stiglitz and Charlton, 2005). Free trade is preferred because liberalisation of restrictions leads to a rise in the level of welfare and improves the average efficiency in a country, allowing resources to be redeployed from low-productivity protected sectors into high-productivity export sectors, and leading to a more integrated world economic system with globalisation being the main feature. Statistics show that from 1950 to 2004, world trade grew at an average rate of 5.9 percent per annum (7.2 percent for manufactured goods) and trade relative to output more than tripled (www.wto.org).

While businesses and consumers enjoy the benefits, critical voices against free trade are becoming louder. Khor (2001), for example, asserts that colonial rules, as well as the imposition of new economic systems, have changed the social and economic structure, causing developing countries to grow more and more dependent upon global trading. Countries are being forced to export more goods, mainly natural resources, and thus, are sucked deeper and deeper into the whirlpool of the world economic system, and consequently, have lost or are losing their indigenous skills, capacity for self-reliance, confidence and the very resource base upon which their survival depends (Khor, 2001). Morris (2001) argues that free trade is unable to promote or sustain the social relationships that create a vibrant community, as its key promise relies on a narrow definition of efficiency. He further points out that by taking precedence over the autonomy, sovereignty and, indeed, the culture of local communities, the transport of capital, materials, goods and people has not helped to maintain a sustainable development of society (Morris 2001).

Despite the different views and controversy associated with free trade, internationalisation and globalisation have become two of the most pronounced industrial trends during the late twentieth and early twenty-first centuries (Button, 2004). Air transport is closely linked to global trade growth and has contributed

significantly to the ongoing economic integration on a global scale. Although the growth trend of world trade has been falling since 2003 and fell sharply in 2008/2009 as a result of the worst economic recession since the 1930s, data from the International Air Transport Association (IATA) shows that about 40 percent by value of international trade is carried by air and around 2 percent by volume (www.iata.org) (Figure 1.1).

Figure 1.1 Relationship between global air freight tonne kilometres flown and world trade



- Global air freight volumes have typically grown quite closely in line with world trade volumes of manufactured goods, for obvious reasons. Air freight is slightly more volatile than overall world trade, because it is the most costly transport mode and so is substituted away from during downturns.
- However, in the past few years the growth of air freight had been rather slower than expected given the expansion of world trade. World trade is expected to decline in 2009 producing a 5% decline in global FTKs.

Source: IATA, 2008

While facilitating the growth of international trade, air transport has grown into an important business in its own right, not only being just that part of economic activity by changing the geographic location of people and goods, releasing resources from their geographical bondage and making available formerly inaccessible utilities to bridge the geographical gaps between goods and services and consumers (Benson et al., 1994), but also contributing to the increase of human satisfaction by providing affordable travel for

everyone in society, thus broadening their leisure and cultural experiences (Air Transport Action Group, 2005).

Assisted by the rapid expansion of knowledge-based services such as accounting, advertising, marketing and distribution, the efficient provision of which has become essential for corporate competitiveness, the separation of such activities from the production process has led to a vigorous development of trade in services. Communication technologies have facilitated the liberalisation efforts in capital and service markets, causing the shift of focus of international trade from manufacturing goods to services (OECD, 1997). In the US, the manufacturing goods dwindled to only 14 percent of its GDP in the early 1980s (Stiglitz and Charlton, 2005). As a response to this trend, “trade in services” was introduced in the Uruguay Round of discussions in 1986 by the General Agreement on Tariffs and Trade (GATT), later called the World Trade Organisation (WTO), which has since become the most dynamic element in world trade. OECD’s statistics showed that between 1980 and 1993, trade in services grew at 7.7 percent per year compared with 4.9 percent for merchandise trade, accounting for more than 50 percent of OECD countries’ FDI outflows (OECD, 1997).

International air transport has since been regarded as a significant part of international trade in services with full commercial features, being able to generate revenues to contribute to national foreign reserves. According to the International Monetary Fund’s (IMF) Balance of Payments Statistics Yearbook, trade in passenger air transport services is defined as passenger services provided by air transport and performed by residents of one economy for those of another. Therefore, a residency approach to trade in aviation services is generally consistent with IMF’s balance of payments accounting. As Weisman (1990) explains that, in principle, a country exports aviation services when an airline (a resident) from that country sells its service to a passenger resident in another country. Data from the IMF shows that the value of world imports of passenger transport services of all modes, including air, shipping, rail and others, was worth more than \$30 billion in 1988 and increased to almost \$90 billion by the year 2002, with an increasing rate of 7 percent per annum except for 2001. Air transport services are generally considered to occupy a large part of that value (www.imf.org).

Recognising its importance to economic growth, national governments have taken a fresh view towards international air transport and have incorporated air transport policies into their overall economic policy considerations. The 1990s saw more countries taking actions to liberalise their international air transport markets at the inspiration of independent economic considerations of the industry (Doganis 2002) with its political and military implications being downplayed.

1.2 International air transport as a commercial business constrained by politics

Air transport is now a big industry in its own right (Hanlon, 1999). It is the world wide web of the 20th century that connects the world closer and the silver needles that sew the world together, enabling people to stay close to their family and friends across the world and help secure the fabric of the economy and their lives (ATA, 2010). According to IATA, some 2,000 airlines carried more than 2.2 billion passengers in 2008 and the value of the goods transported by air represented 35 percent of all international trade. The industry generated a total of 5.5 million direct jobs, contributing \$408 billion to global GDP, around 7.5 percent of the total (Air Transport Action Group, 2008).

Paradoxically, air transport was not invented in response to a clear, identifiable commercial demand, such as railways that were developed to meet the needs of the British coal industry (Staniland, 2003). The course of its growth was marked with such objectives of serving the nation in the event of war to protect its territory and sovereignty and of a reflection of national prestige. Subsequently, very strict international regulation came about before any commercial industry had developed (Staniland, 2003).

This view has dominated people's mindset for many years, leaving air transport to be treated differently from other commercial businesses due to its close link with national security and political power in the international arena. As a direct result, air transport activity has evolved from more political and military considerations, with governments having unrestricted control over international air services (Karou, 2000). "International aviation is not just another problem in a changing economic system, though it is that, international civil aviation is a serious problem in international relations, affecting the way governments view one another, the way individual citizens view their own and

foreign countries, and in a variety of direct and indirect connections the security arrangements by which we live” (Lowenfeld, 1975). From America’s perspective, aviation would have a greater influence on its foreign policy than any other non-political considerations, as Adolf Berle, the Assistant Secretary of State in 1938 warned. Serving the political interest of a state is the overarching objective of any commercial aviation activity, with national carriers bearing a far more political significance in the eyes of politicians. International air transport, thus, are decided by governments which view it as an instrument akin to foreign policy based on reciprocity and privileges which sometimes have nothing to do with air transport, rather than a commercial business (Sochor, 1991).

According to Chicago Convention¹, governments, that are the treaty signatories, are the authorised parties represented by their diplomats negotiating and trading the specialised “rights” of airspace access, with prioritised considerations given to the national sovereignty and security rather than the commercial demand for air travel. These rights are further elaborated into nine freedoms of air traffic rights (Table 1.1), the trading of which is conducted in a resolutely bilateral fashion, with each side being committed to a kind of aeropolitics of restriction and artful compromise, classic zero-sum diplomacy, in defence of the home carrier’s market share (Havel, 1997). Government bartering, not the entrepreneurial acumen of airline managements, has been the sole instrument of new market development in this most technologically precocious industry over the decades (Havel, 1997).

Table 1.1 Nine freedoms of air traffic rights.

Traffic rights	Definition
First freedom right	The right or privilege, in respect of scheduled international air services, granted by one State to another State or States to fly across its territory without landing
Second freedom	The right or privilege, in respect of scheduled international air

¹ Chicago Convention was signed by 53 signatory states, which establishes rules of airspace, aircraft registration and safety, and details the rights of the signatories in relation to air travel. It also established the International Civil Aviation Organisation (ICAO), a specialised agency of the United Nations charged with coordinating and regulating international air travel.

right	services, granted by one State to another State or States to land in its territory for non-traffic purposes
Third freedom right	The right or privilege, in respect of scheduled international air services, granted by one State to another State to put down, in the territory of the first State, traffic coming from the home State of the carrier
Fourth freedom right	The right or privilege, in respect of scheduled international air services, granted by one State to another State to take on, in the territory of the first State, traffic destined for the home State of the carrier
Fifth freedom right	The right or privilege, in respect of scheduled international air services, granted by one State to another State to put down and to take on, in the territory of the first State, traffic coming from or destined for a third State
Sixth freedom right	The right or privilege, in respect of scheduled international air services, of transporting, via the home State of the carrier, traffic moving between two other States
Seventh freedom right	The right or privilege, in respect of scheduled international air services, granted by one State to another State, of transporting traffic between the territory of the granting State and any third State, with no requirement to include such operation any point in the territory of the recipient State, i.e. the service need not connect to or be an extension of any service to/from the home State of the carrier
Eighth freedom right	The right or privilege, in respect of scheduled international air services, of transporting cabotage traffic between two points in the territory of the granting State on a service which originates or terminates in the home country of the foreign carrier or outside the territory of the granting State
Ninth traffic right	The right or privilege of transporting cabotage traffic of the

	granting State on a service performed entirely within the territory of the granting State
--	---

Source: ICAO Manual on the Regulation of International Air Transport (Doc 9626, Part 4)

Such a stringent regime was acceptable given that in the circumstances when sovereignty as well as economic nationalism was overemphasised at the close of World War II, with concerns for national security overwhelming the economic considerations of the industry (Schenkman, 1955). Attitudes of those nations attending the Chicago Conference towards international air transport were divergent. Countries like the US were strong advocates of a liberalised international aviation system, which was believed to be able to support the expansion opportunities and increase demand for American airlines that had developed during the war. Others represented by the UK severely opposed to such a liberalised idea, casting such questions as whether it would be safer to separate commercial air transport from the general world economy as world peace had not been secured (Schenkman, 1955). Even if there would be a practical possibility of developing a network of air transport which would enable airlines to pursue the economic benefits of such operations, concerns remained that such a liberalised regime would be exploited by the US, the sole country at that time capable of developing a powerful industry with extensive networks that were likely to dominate international aviation (Staniland, 2003). In the absence of any permanent arrangements agreed by all participating countries, bilateral discussions with restrictions on airline operations and investment became the second choice to none, which at least allowed the industry to fulfil its essential mission (Schenkman, 1955). The national governments of the signatories, thus, take a key role in formulating their international air transport policies in line with the international regime.

These legally binding Air Services Agreements (ASAs) reached between governments tend to typically include commercial constraints with tight controls on the following areas:

- the number, size and destination points of flights that can take place between countries;

- the type of direct connecting services or codeshare arrangements that airlines can offer;
- the airlines' freedom to set their own fares, often requiring fares to be approved by one or both of the contracting nations; and
- majority of the ownership and effective control of an airline must reside with nationals of the relevant country (UK CAA 2007).

The political and military considerations of international air transport have affected considerably the progress of the industry. World trade can not exist without the facilitation of transport, nor can it serve the common good of nations and peoples unless it flows freely to every part of the world with a minimum artificial interference (Schenkman, 1955). The boundaries that slowed its progress were those invisible political ones which nations had to maintain for their real or fancied security, or to protect their national economy or international prestige and position (Schenkman, 1955). "It is the tragedy of air commerce that the nations of the world have never been able to agree on the kind of political boundaries needed in air space" (Schenkman, 1955).

Operated under the protection of IATA, widely accused of being a cartel that created a regime of enabling airlines to set a higher fare and tariff at the cost of consumers (Tucker, 1982), transnational air transport was arranged by governments through bilateral negotiations which escaped the rigours of competition. The mechanism thus developed has constrained the ability of airlines to operate on a fully commercial basis, due to: i) the operational restrictions precluding airlines from entering into a market at their own free will; and ii) the ownership restrictions limiting the ability of airlines of one country receiving capital investment from another country (Smyth and Pearce, 2007). These constraints have not only prevented the air transport industry from growing faster into a truly global industry but also exploited the consumers' right to enjoying the benefits offered by a fully liberalised industry.

1.3 Liberalisation of international air transport

Global economic growth in the 1980s resulted in governments to remove the restrictions on international trade to further promote the free movement of people and goods. The

US, after deregulating its domestic airline industry and seeing the benefits of such deregulation, together with its bilateral partners, pioneered the initiative of lifting the constraints on international air transport operations in the early 1990s by concluding the so-called Open Skies agreements.

Such a radical policy change in the US was mainly triggered by the belief in the idea of liberalisation which holds that business would only optimise their returns on investment through competition in a free market. Strong airline traffic in the 1970s and 1980s had enabled the US carriers to develop extensive domestic networks and improved their productivity and efficiency. Expansion into international markets with more traffic right freedoms would facilitate US carriers to achieve economies of scale. Being convinced that the benefits of expanding into global markets for the US carriers could only be achieved through lifting the restrictions on traffic rights, the US government regards Open Skies as the most effective mechanism, which would help sweep away the majority of the traditional limits on traffic rights and allow full pricing freedom, with an aim of creating a liberalised operational environment in international markets.

Unlike standard bilateral agreements, Open Skies agreements eliminate the traditional roles played by governments in determining routes, designating the number of the airlines that could operate in the market, controlling the frequency of services and tariff approving. Instead, under an Open Skies agreement, it is the market forces that determine such matters. Airlines of one party may operate as many flights as it wishes so long as there is a need in the market, restricted only by safety concerns and airport capacity issues (Meyer, 2002).

Proponents of Open Skies contend that such arrangements stimulate airline competition, which in turn leads to lower fares and better service to the travelling public. (Meyer, 2002). They argue that Open Skies permit aviation markets to grow in accordance with demand, thereby allowing airlines to offer more convenient and affordable air service to both passenger and shippers. This growth, they argue, leads to economic expansion for the other party to the agreement. Although the oldest Open Skies agreements date back only a decade, evidence suggests that the proponents of such agreements are correct. In numerous instances, growth in Open Skies aviation markets has significantly outpaced growth in similar markets governed by traditional, more restrictive bilateral treaties.

Furthermore, in Open Skies market, service levels have increased while fares have fallen (Meyer, 2002).

However, there remain opponents of Open Skies arrangements, most notably, governments of nations that subsidize national flag carriers which therefore fear the consequences of unrestrained competition against more efficient foreign carriers (Meyer, 2002). Other opponents include airlines themselves, which may benefit from their positions as incumbent carriers in markets closed to new entrants. Additionally, some airlines industry observers have warned of the risk of “destructive competition” among airlines that may accompany a move toward a deregulated Open Skies environment (Meyer, 2002).

The divergent views have not stopped the spreading of Open Skies to the rest of the world. When formulating policies to promote liberalisation, governments tend to have different considerations due to their specific social and economic systems, with an attempt to achieve their objectives with minimum opposition from the various stakeholders. Different policies and approaches have been adopted in the exercise, hence resulting in different stages of the liberalisation process.

Countries like Canada, Australia, New Zealand and Singapore are among those first that have moved in concluding Open Skies agreements with the US, thus becoming a fully liberalised market encouraging competition. The European Union (EU) has liberalised its air transport market within its Member States to its full extent without any restrictions on investment and operations, which goes hand in hand with the integration of its common market. Australia and New Zealand have created an Open Aviation Area (OAA) which has removed all the restrictions on bilateral air transport operations. Developing countries in Asia, South America and Africa, on the other hand, have been more conservative in accepting the Open Skies concept, taking a progressive and gradual approach towards the liberalisation of their international air transport markets. Table 1.2 summarises the differences between traditional ASAs, Open Skies and OAA.

Table 1.2 Summary of key points in traditional ASAs, Open Skies and OAA.

Type	of	Capacity and	Setting	6 th to 9 th	Foreign	Cabotage
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agreement	frequencies	fares	traffic rights	ownership and controls allowed	
Traditional ASAs	X	X	X	X	X
Open Skies	V	V	V	X	X
OAA	V	V	V	V	V

(Remarks: X represents that the traffic rights are restricted while V refers to the traffic rights that are allowed).

Source: adapted from CAA, 2007

1.4 China's economic reform and its international air transport policy

When the US deregulated its domestic airline industry in 1978, China also launched its economic reform with the aim of transforming its centrally-planned economy into a socialist market economy. The objective of the policy change was to relieve the poverty in urban areas and to achieve modernisation for the nation. Since then, China has experienced a remarkable economic growth with an average growth rate of more than 10 percent per annum. When the world economy suffered from the most serious recession in 2008 and 2009, China remained one of the few countries maintaining 8 percent growth rate and overtook Japan to become the second largest economy in 2008, with a GDP of 30.07 trillion Yuan (US\$4.42 trillion). According to the World Competitiveness Yearbook published annually by the International Institute for Management Development (IMD), of the 57 economies chosen to be analysed, China's overall competitiveness kept rising, with its world ranking jumping from 18th in 2006 to 15th in 2007, with some of the major factors behind such a rising being its strong economic performance, structural reform and infrastructure investment (www.chinadaily.com).

Air traffic grew rapidly over the decades with a massive 103-fold increase in RPK from 2.79 billion in 1978 to 286.56 billion in 2008, and a 121-fold increase in RTK from 0.097 billion in 1978 to 11.77 billion in 2008 (www.caac.gov.cn). In 2008, China's air

transport industry had 286,000 employees and carried 191.9 million passengers, generating 304.7 billion Yuan (US\$45.0 billion) in revenue (www.stats.gov.cn), ranking the second among the ICAO Member States, just behind the US (www.icao.int). Ironically, none of the Chinese airlines were ranked in the top twenty world airlines in terms of traffic carried or in terms of financial performance in 2008 (www.atwonline.com).

Historically, air transport in China has been controlled and managed by the air force. This is due to the fact that air transport is a part of the national defence system with military significance. International air transport agreements have been negotiated bilaterally and concluded only with those that recognised the status of the People's Republic of China (PRC) and established official diplomatic ties. Consequently, international air transport has been limited to only a few "friendly countries". The Civil Aviation Administration of China (CAAC), the government agency charged with the responsibilities of overseeing the air transport industry in China, reports to the Ministry of Foreign Affairs (MFA) for policy advice on bilateral air transport agreement negotiations with its foreign counterparts. International air service is regarded as a political mission to strengthen the bilateral relations. Hence, the reform of the industry only started in 1987, with the corporate operations being separated from the government functions by creating six carriers based on CAAC's regional administrative operations. Numerous policies have been initiated and implemented afterwards, eliminating the restrictions on the economic aspects of the operations to encourage competition. Although magnificent structural changes have taken place as a consequence of the political reform, China is still on its way towards a full liberalisation. Believing that air transport is to a great extent an integral part of the nation's defence system, China holds that international air transport policy is an element of its foreign policy, which should be deployed to support the nation's overall strategic and military objectives. Enthusiasm for liberalising the international air transport market has been high and low in response to both internal and external environments. Bilateralism still dominates its international air transport negotiations, with liberalised Open Skies arrangements being moderately accepted. The government is more concerned about the health of its airlines rather than the overall effects that an effective transport system would have on the economy as a whole.

Until 2003, there had been no explicit policy with respect to international air transport spelt out in any government white paper, such as the Strategic Five-Year Plan. Liberalisation had been an unacceptable term to use, the whole concept being a very sensitive issue and one not widely accepted across China. As a consequence, each bilateral agreement is dealt with on a case-by-case basis, thereby giving rise to flexibility but also uncertainty (Forsyth et al., 2006). Political and diplomatic implications are given priority considerations despite economic gains being taken into account. Of the 110 ASAs China had signed by the end of 2007, only 28 contained more relaxed traffic rights allowing multiple designations and unrestricted capacity arrangements (www.caac.gov.cn).

1.5 Studies on China's international air transport policymaking

There has never been a lack of interest in studying the liberalisation of international air transport worldwide, with a rich literature documenting the industry's regulatory reform. Briefly, the literature can be grouped into the following categories:

- The economic impact of the liberalisation of the industry focusing on the overall performance and the social benefits, as documented by scholars such as Ahmed and Almarri, 2006; Button, 1990, 1997, 2004, 2009; Docherty, 2004; Doganis, 2007; Hooper, 1997, 2003; Hui et al., 2004; Kasarda and Green, 2004; Kassim, 1996; Levine, 1990, 2006; Bailey et al 1986; Oum, 2003, 2007; Oum and Yu, 2000, 2001; Shaw et al., 2009; Taneja, 1980, 2003; Williams, 1990, 1994, 2003; Zhang et al., 1998, 2003, 2006, 2009;
- Strategies adopted by airlines and airports in response to competition in a relaxed operational environment and the challenges faced by management in tackling the tough environment (Freeman and Lam, 2002; Findley, 2003; Button, 1990, 1997, 2004, 2009; Hooper, 1997, 2003; Loo, 1999; Oum, 2003, 2007; Rhoades, 2005);
- Political and legal considerations with respect to liberalising domestic, bilateral and multilateral air transport markets; examining the constraints and driving forces for more open and relaxed markets (Dempsey, 2004; Kyrou, 2000; Havel,

1997, 2001, 2009; Lelieur, 2003; Levine, 2006; Sochor, 1991; Staniland, 2003; Wassenbergh, 2003).

Reviewing the existing literature, two gaps have been identified. Firstly, much attention has been given to the US and EU, while less has been directed to China, given the fact that the nation's industry reform started later than that in western countries and is still an ongoing process. Scholars such as A. Zhang (1998, 2003, 2006, 2009), Le (1997), Hui (2004), Shaw (2009) and Oum (2003, 2007) have conducted a handful of research on China's air transport industry, but only narrowly analysed the economic aspects of the industry with their works predominantly concentrating on such issues as airlines productivity, efficiency, competitiveness, their strategies in response to competition, and airports privatisation and productivity. Dougan (2002) analysed the policymaking of the country's aviation industry from a political economic perspective but only focused on domestic issues, with little done on its international air transport policy which is more international-oriented. Williams (2009) endeavoured to understand the driving forces for the changes of China's air transport industry from both domestic and international sources, but with limited analysis directed to its international markets. Undeniably, their efforts have contributed significantly to the understanding of China's air transport industry, its development and growth, and its prospects and challenges.

Secondly, when taking international air transport as an element of international trade, it is regrettable to note that there have never been any studies on the subject matter in China. Over the decades, sinologists such as Kenneth Lieberthal (1988), Michael Okdenberg (1988), John King Fairbank (1976), David Shambaugh (1994), Samuel Kim (1994), Steve Chan (2006), Quansheng Zhao (1996), Thomas Robinson (1994), and Yufan Hao (2006) have conducted enormous research on China, mainly focusing on its political, economic and security aspects, and in particular, its bilateral relations with the major world powers such as the US, Russia, Japan and the EU. They have studied China from an international relation's perspective, examining and analysing how the country's foreign policy is made, what the country's security considerations are, and what are the implications with respect to the policy to the other country and the rest of the world. Their contribution is unprecedented in facilitating the mutual understanding between China and the rest of the world.

Since the 1990s, studies on China's international trade policy have started to draw scholarly attention, resulting in a handful of publications. However, it has remained in the domain of foreign policy, which has enlarged its agenda to include both economic and cultural issues since the 1990s (Zhao, 1996). This is due to the shift of China's national priority to that of economic growth, which is viewed as one of the top national interest. As a policy guideline, it not only dominates domestic reform but also governs the direction of China's foreign policy (Zhao, 1996). Since 2000, a proportion of research has been focused on China's interactions with its major trading partners such as the US and has examined how the two parties bargain with each other. Several other works have examined China's policymaking process by focusing on international environment as well as its domestic politics with an attempt to assess the impact of these factors on the country's policy outcomes. For example, Feng (2006) examined China's entry into the WTO and argued that it was a state-led, leadership driven, and top-down process, with the top leaders playing a decisive role in the course. Zeng and Mertha (2007) together with the contributors in their collection examined the impact of domestic sources on the country's foreign trade policymaking and argued that lobbying patterns in China are becoming increasingly similar to those observed in advanced industrialised states, with ranked agencies, ministries, sectoral interests, and even transnational actors becoming increasingly able to influence both the possibility that China will reach a trade agreement with its trading partners and the terms of such agreements. The analysis has provided an in-depth insight on China's international trade policymaking process as well as its international behaviour, though mainly based on the findings of the research which treat foreign policymaking as case studies of foreign policy making in general (Zeng and Mertha, 2007).

Another strand of literature is devoted to analysing the implications of China's accession into the WTO for the country's economy and society. They are engaged in assessing the impact of its WTO membership in terms of such issues as income disparity, social welfare and industrial development in China, but without much attention given to the evolvement of its trade policymaking in the shadow of WTO membership (Zeng and Mertha, 2007).

The lack of study on China's trade policymaking can be attributed to the subject matter being cross-disciplinary, requiring the examination of essentially domestic arguments about industry policies, as well as issues concerning international trade, and, indeed, international politics (Staniland, 2003). In terms of China's international air transport policymaking, a catholic approach to concepts and theory is particularly required for any research, since the evolution of air transport worldwide has involved both public policy and business strategy and entailed decision-making that has occurred at international, national and corporate levels (Staniland, 2003). It can also be seen that such a study would require a tremendous amount of work in order to analyse the various aspects in a longitudinal context, which would demand many sources. Another reason is the shortage of information available for conducting empirical research, as China has not developed a mechanism or a system to declassify government documents which are invaluable for data collection, although a burgeoning literature of memoirs and memorials, as well as interviews with those who know Chinese elite politics and key policy makers, has become accessible (Hamrin, 1994). Furthermore, the biggest challenge lies in the lack of an overall embracing analytical model or framework that can be applied to such analysis due to its unique positioning, i.e. caught between the domestic economic and foreign policy machines (Cohen, 2000).

The shortage of research has raised questions about the process of China's international air transport policymaking, which, to date, has remained rather opaque to outside observers. It has also drawn the attention of this author to be inquisitive with such questions as:

- What are the considerations of the government in determining regulatory reform with respect to its international air transport?
- What are the driving forces that facilitate to shape China's international air transport policy?
- Is it the international environment or domestic considerations that influence China's international air transport policymaking?
- If both have an impact, what are the factors that drive changes and to what extent do they have an impact?
- Are these factors evolving? And how have they evolved over the years?

1.6 Research aim and objectives

Given the prominent economic power China possesses today and its potential for the future, it is important to understand more about China's international trade policymaking, its approach towards liberalisation and its international behaviour. With the above in mind, it is the aim of this research to examine and analyse the changing nature of China's international air transport policy with a view towards helping fill the gaps in knowledge identified from the preceding discussions. Specifically, this research is aimed at identifying the factors that have had an impact on the country's policymaking process, establishing whether these factors are evolving over the years and determining how they are interacting with each other in leading to the policy outcome, hence, shedding light on the country's international trade policymaking and its international behaviour. It is believed that significant development at both international and domestic levels are fundamentally changing the conventional approach of policymaking and the weight of these driving forces is changing as the environment changes.

This analysis is focused on the country's international rather than domestic air transport policymaking for the following reasons:

- It has been heavily regulated by international regime bilaterally as well as by national governments, and is treated differently from other industries;
- It is a truly commercial business, generating economic benefits to individual nations and the world as a whole, but carries significant political and national defence implications; and
- It is part of international trade, facilitating globalisation, but itself is still undergoing the process towards full liberalisation.

To achieve this aim, the following specific objectives have been identified:

- To review China's international air transport policymaking process in order to identify what are the factors that affect the decision-making process;
- To establish whether the factors stem from the international environment, domestic considerations, or result from institutional and individual behaviour;

- To discuss, examine and analyse these factors to determine how they interact with each other and have an impact on the policy makers, leading to the policy output;
- To examine and analyse how the policy has evolved over the years and to establish whether the factors are changing;
- To determine which factors have played and are still playing critical roles in the policymaking process; whether their roles are changing and whether such changes are time-and issue- constrained;
- To make recommendations to governments, industry organisations and other stake holders regarding best practice for the benefit of the industry, the nation and the global community as a whole; and
- To further the understanding of China's international trade policymaking process and shed light on the understanding of China's international behaviour.

1.7 Structure of the thesis

The thesis will be arranged into nine chapters. Chapter one is the introduction which sets the scene for the rest of the work. It briefly discusses the features of international air transport as a trade in service and its commercial nature but with a strong political implication. It reviews the process of liberalisation of international air transport which goes from regulated regime to a relaxed Open Skies and OAA, and outlines the development of China's international air transport sector and the country's approach towards liberalisation. It identifies the academic gap in the study of China's international air transport policymaking and defines the research aim and objectives that the researcher is endeavouring to achieve. This chapter also outlines the structure of the thesis and briefly describes the main contents of each chapter.

Chapter two describes the theoretical framework for the analysis of the research. It starts with the concept of international trade policymaking and explains its inter-disciplinary nature, which is straddling the domains of both foreign policy and economic policy. It discusses a variety of different theories applied by both economists and political scientists who have attempted to analyse the policymaking process and examines the pros and cons of each theory. It describes in more detail the Micro-Macro Linkage

Approach developed in the 1990s by Zhao and argues that it is believed to be the most appropriate model to be applied to this research in analysing China's international air transport policymaking.

Chapter three spells out the methodologies used in the research. It starts with the discussion of the advantages and disadvantages of both qualitative and quantitative methods in social science research and argues that the qualitative approach is more suitable for this research. It analyses the benefits of a case study strategy and explains the rationale for selecting China-US, China-UK and China-Netherlands as the cases for study in this research. The chapter also describes explicitly how the data is collected and analysed, and addresses ethical issues in data collection and analysis.

Chapter four is the literature review with studies of China's international trade policymaking and, in particular, its international air transport policymaking is reviewed and examined. It reveals that although a good volume of research has been conducted in the realm of the country's international trade policymaking and international air transport policymaking, the two have never been linked together for a synthesised study. The findings and conclusions of the previous research have provided a good insight on the subject matter and will help this author to advance the research further

Chapter five provides a comprehensive overview of China's air transport industry, starting with the introduction of its overall performance in relation to its economic growth and other transport modes. It discusses in detail the three major hubs and those airlines based therein, both passenger and cargo operators, and examines their development, operations, strategies and challenges in the competition. In addition, the chapter discusses China's air transport policy and its evolvement over the last three decades and explores its impact on the industry's development. The chapter presents a more systematic description of China's air transport industry, its policy and its development.

Chapters six and seven are the key elements of this research, focusing on the three country-pair markets chosen for case studies. They begin with a brief introduction of the air transport industry of each of the three countries, namely the US, UK and the Netherlands, followed by a discussion of respective government's view towards

liberalisation and its bilateral aviation relations with China. The chapters then continue to discuss in more detail, respectively, the various rounds of bilateral negotiations between China and each of the above three countries, exploring and analysing the considerations and expectations of the airlines, airports and governments before the consultations, the strategies and tactics adopted by both sides, as well as the outcomes following the consultations. They then compare the agreements reached out of each round of discussions and analyse the motives of both parties for coming to a compromise, despite the expectations of both sides can be either identical or divergent. Both passenger and cargo policies and agreements are analysed. The two chapters also examine the international environment, domestic circumstances, performance of the airlines as a consequence of implementing the arrangements before each round of discussions; discuss the actions taken by various stakeholders before, during and after the discussions; and assess how the various factors have affected the policymakers who eventually make the decisions and come to an agreement with their counterparts.

Chapter eight is another critical component of the thesis. Starting with the revision of the theoretical model and summary of the key points of the agreements chronologically reached between Chinese government and its three counterparts, the chapter goes on to apply the Micro-Macro Linkage Model for an explicit analysis. It, first of all, identifies the factors at international, regional and bilateral levels; politically, economically, strategically and operationally; and discusses how these factors influenced the country's national and industry policies. It then continues to identify the factors at national, societal, institutional and individual levels and examines how these factors react to the factors at the international, regional and bilateral levels; how they interact with each other and converge on the policymakers. It analyses critically each of the factors identified, explores how each of them has affected the mindset and considerations of policy makers in formulating the policies, strategies and tactics before, during and after the negotiation process and assesses its weight in influencing the policymaking process. It further establishes the evolving nature of the factors and determines how the time- and environment-constrained nature of the factors has influenced the policymaking process. By comparing and contrasting the identified factors, the researcher argues that international air transport policymaking in China is influenced by all factors at all levels with industry interest groups being involved in the whole process, which is significantly

unique compared with that in other industries in China. International regime has played a critical role in influencing the country's overall economic policy directions, which in turn has determined how the trade policy at industry level is formulated and developed. The political and economic relations at regional and bilateral levels have played a pivotal role in influencing China's consideration in determining the overall policy towards the country pair market, while the domestic sources such as interests groups, media and institutions are capable of influencing the decision makers only to a certain extent to decide to what extent that particular round of discussions will lead to a compromised policy outcome. It concludes that factors that have an impact on the policymaking process have been evolving and their weight in that process is environment-, time- and issue-related and constrained. Some factors are able to play a bigger and more decisive role than others in certain circumstances, but may not play a part in other instances. No factors have remained dominant in dictating what the policymakers will come up with a policy outcome, but rather, it is a combination of the factors that have an influence. A particular policy outcome results from the careful and prudent considerations of various factors which are traded off by policy makers.

Chapter nine is the conclusion of the research. It summarise the factors and discusses the dynamic and changing nature of the policymaking process in China's international air transport market. It highlights the contribution of the current research to knowledge while at the same time addresses its limitations and identifies the areas where more research should be undertaken. It provides recommendations to policymakers in terms of developing a more sound and systematic approach in formulating the international trade policy with respect to international air transport and suggests that stakeholders should be more involved in the policymaking process to ensure that the policy outcome reflects the wider interest of the society, rather than a single industry. The chapter also identifies the limitations of the model and suggests a revised framework to be applied to the subject matter.

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Chapter 2 Analytical framework

2.1 International trade policymaking

In attempting to examine and analyse the evolutionary changes in China's international air transport policy, the first task is to determine a framework applicable for such analysis. International air transport exemplifies international trade features but with a higher political involvement than other trade sectors. The policymaking of international air transport reflects a nation-state's international trade policy considerations, which is the central spine of the country's international economic policy (Pastor, 1980).

Trade policy is defined by Cohen (1968) as the sum total of actions by the state intended to affect the extent, composition and direction of its imports and exports of goods and services. It deals with the economic effects of direct or indirect government intervention that alters the environment under which international transactions take place (Kerr, 2007). Vested interests are at the heart of trade policy, with government actions viewed as redistributive and open to influence (Kerr, 2007).

Since the late 1970s, when policies started to shift towards neoliberalism, encouraging governments to promote free trade across their borders to achieve national prosperity and growth (Moon, 2000), economics has become as important as security in international relations. International trade policy has become increasingly interlinked with a nation's foreign policy, with their relative significance and impact on other issues having been dramatically increased (Hocking and Smith, 1997). Economic growth via international trade has become a priority on the agenda of a government's national strategy, with economic objectives always being reflected in a nation state's foreign policy. As Alexis Johnson, Undersecretary of State of the US, argued that economic considerations would dominate foreign policy over the following decade as security concerns had dominated the previous two (Johnson, 1972). Prioritised significance of economics would be one of the two particularly noteworthy changes to the foreign policy environment and the nature of foreign trade policy has become a far more complex issue as new problems crowd upon it (Rosenau, 1987). Governments would strive to reconcile politics and economics, both in the objectives chosen and the

methods used, so that they do not conflict but mutually reinforce their preferred policies (Bayne and Woolcock, 2007).

The increased exchange of economic activities and rapid growth of international trade across borders brings about an interdependent relationship between nations. Governments are seen more and more often sitting at tables negotiating for trade agreements, trying to secure a deal that would best satisfy their respective needs to protect while at the same time optimise their national interests. However, because of the complicated and multi-faceted nature of international trade issues and the sophisticated negotiations involving another country which may or may not share any identical political, social, economic and cultural features at all, governments and their institutions tend to find themselves struggling between powers, benefits, interests and other considerations. Although increased economic interdependence helps the advance of globalisation, it adversely makes the international trade policymaking much more complicated, bringing in more issues and actors for consideration in the process (Bayne and Woolcock, 2007).

These phenomena have caused unprecedented attention from both academia and industry practitioners who have attempted to address the subject matter from both an economic and political perspective with a wealth of literature being produced. Economists take it as an extension of domestic economic activity, trying to understand how international economic activities could help to maximise domestic economic objectives, while political scientists treat it as a political game played by various stakeholders, thus focusing the analysis on the politics involved in the policymaking process. International relation theories are borrowed to examine the bilateral diplomatic and military relations between the two countries concerned, which are considered fundamental in formulating foreign trade policy. Different theories have been developed with an aim of analysing the different roles played by different factors involved in the process of policymaking, with a view to attempting to deepen the understanding as to how and why governments and other actors in the process of trade policy making and negotiation behave in the way they do. Despite the flourishing amount of literature, a gap still exists in current academic studies (Bayne and Woolcock, 2007), as observed by Cohen (2000), in that the subject has seldom been studied and analysed as a separate

and distinct phenomenon, due to its unique position straddling “the two highest priorities of the modern nation state: economic prosperity and national security”. Like the two sides of a coin, it is, on the one hand, “the external dimension of domestic economic policy”, while on the other hand, it is the “economic component of the foreign policy” (Cohen, 2000).

2.2 A critical review of the analytical approaches

Analysis undertaken in trade policy has, over time, had to deal with increasingly complex issues, in part as a result of the expanding set of constraints that have been imposed on trade policy makers as trade liberalisation has become a generally accepted goal of government (Kerr, 2007). This is also because trade policy analysis has had to examine questions that are long considered in the purview of domestic policy which has to take into account a wider range of considerations in domestic circumstances, as, in many cases, changes in trade policy may be detrimental to domestic vested interests and to the benefits of foreign competitors (Kerr, 2007). Furthermore, trade policy interfaces increasingly with science, such as food safety and environment, and the analysis of consumer preferences, such as animal welfare and child labour, as well as social policy, such as sustainable development and labour standards (Kerr, 2007).

As the questions encompassed by trade policy are wide-ranging and multi-faceted (Kerr, 2007), both economists and political scientists have developed divergent theories, analytical tools and models in order to analyse the manners in which various factors interact in the course of formulating the policy (Baldwin, 1996), each of which can be proved and supported by selected cases in the particular context. They approach these variables from different perspectives with the intention of understanding how the policymaking process works through what could be considered to be a “black box”.

2.2.1 The economic perspective

Economists tend to analyse the making of economic policy through a normative approach, modelling policy choices as the equilibrium outcome of a well-specified strategic interaction among rational individuals (Persson and Tabellini, 2000), who act and react within the institutional context which shapes their behaviours (Muscatelli,

1996). Rational policymakers are capable of defining clearly the problems, identifying the aims, considering the alternatives, developing clear criteria for choice and monitoring the decisions (Dumbrell, 1997). While being rational, there is a tendency that they will go for the optimisation of achieving their personal objectives for the benefit of their own welfare and self-interest, which may or may not coincide with those of the wider community or the electorate whom they represent (Muscatelli, 1996). In this pursuit, they will follow their personal preferences for the goods and services available in order to seek to be elected or re-elected. However, when operating in a world which is not ideal but full of acute difficulties, ranging from unreliable information to time and electoral pressures, policymakers have to make choices on the basis of picking the least unsatisfactory option as a result of various constraints: the course of action which exhibits minimally satisfactory standards of acceptability is a basis upon which to proceed (Dumbrell, 1997).

The potential conflict between individual and social objectives leads to several important and related questions which economists struggle to address. For example, Muscatelli (1996) challenged the rational model with the following questions: “If there is a conflict which emerges between the pursuit of self-interest on the part of political and economic institutions and the wider community, what mechanisms can be devised to ensure the society’s welfare is maximised?” “What are the potential conflicts between the pursuit of economic welfare and other social and political objectives, such as democracy and social justice?”

A variety of models have been developed to explain the determination of domestic and international politics within this economic self-interest framework (Baldwin, 1996). The analytical tools used by economists working to address this type of question are by no means novel, with Muscatelli (1996) observing that the use of game-theoretical analysis was reminiscent of similar applications in the areas of welfare economics and industrial economics.

Although the rational choice model is useful in giving explanations and insights into making choices within the bounded alternatives available, it is not short of criticism. There are certain other factors which are involved in international economic policymaking for which economics fails to offer any answer, for example, national

security concerns and environmental considerations (Dam, 2001). Dam further pointed out that most of the public disputes over an economic approach to international economic issues did not revolve around non-economic values, but rather were a by-product of the political system through which international economic policy decisions were actually made. For example, the metrics that economics used to calculate international economic issues leading to a policy result were regarded as something that was controversial.

Another drawback is the neglect of the role played by institutions and ideology in shaping trade policy. Institutions, as Muscatelli (1996) claims, are not only exogenous constraints restricting the economic behaviour of policymakers, but able to respond to economic phenomena to reflect the changing context as a two-way interaction. Goldstein (1988) see institutions as the embodiment of prevailing policy ideas which, once created, ossify, though sometimes enduring long after the ideas which give rise to them have lost favour. She describes the institutions as annual sediment on a flood plain, slowly building up but powerfully influencing the river flow. Levine (1994) claims that it is the ideas and attitudes of economic decision-makers, whether simple and intuitive or highly complex and formally articulated, that structures their environment for choice, informs their consideration of various courses of action, and provides rationalisations for the choices that are made. Baldwin (1996) criticises how economists simply apply the economic approach universally in their analysis of international economic policymaking by presuming that every country operates within identical political and social circumstances, which, in reality, are both dynamic and divergent. Another weakness of the economic perspective is its ignorance of the changing nature of society and environment over time. Thus, the lack of appreciation of such changes causes its failure to explain the evolving factors that shape the economic policy.

Suettinger (2003), with his personal experience in serving various senior positions in the US government, casts significant doubts on the rational model of foreign policymaking. He believes that the process of foreign policy making is a “strategic analysis on both sides of the goals and intentions of the other”. He asserts: “first, foreign policies are not the product of pristine calculations of national interests by trained experts with all the

facts at their disposal. Rather, politics are the result of a profoundly political process in which differing, sometimes competing, domestic interests, bureaucracies and individuals affect the outcome. Although some of the key players are well-informed experts, they are often working with incorrect or incomplete information, as well as inaccurate assumptions and cultural prejudices. Second, strategic assessments that extrapolate historical or ideological trends and project future policies and behaviours are likely to be wrong, as they seldom take account of the domestic politics of decision-making or the effect of unpredictable events that often drive the process” (Suettinger, 2003).

In an attempt to understand the mindset of economists, who acknowledge that politics is important and that foreign trade policy represents the interaction of politics and economics but still leave political analysis aside, Pastor (1980) argues that economists tend to stress the distinctiveness and incompatibility of political and economic analysis which is not helpful in explaining the political process or describing the foreign economic policy in the comprehensive and systematic way that would permit one to draw conclusions about the political causes or consequences. As a consequence, no guide or conceptual framework is available to help understand the politics of policies as diverse as foreign trade policies and to state a proposition about how it is made.

2.2.2 The political perspective

Likewise, political scientists attempt to address policymaking from a political perspective, believing that policymaking is an inherently political process that centres on perceptions, value judgements, the setting of priorities, the making of choices and the distribution of choices (Cohen, 2000). Cohen argues that no economic policies are made that are 100 percent free of political overtones which try to strike a balance of equity versus efficiency. Whether to emphasise social fairness or economic efficiency raises the very basic question regarding to what extent government intervention in international economic relations is desirable. When both the national security and domestic economic well-being, which are two separate realms, are convened to be the goals that the national government wishes to achieve through international economic activities, considerations of optimising the national economic strength will take priority to become the central component in world politics, since economic strength is widely

recognised as having become part of a broader definition of national security (Cohen, 2000). The pursuit of such not necessarily complementary internal and external goals creates a situation whereby the international trade policymaking process is characterised with a juggling act that is reconciled between conflicting domestic political pressures, domestic economic policy objectives and foreign policy priorities (Cohen, 2000). Politics, therefore, is played in the whole process where influences can be exerted, thus generating a heated discussion as to what factors would play a bigger role. Ikenberry et al. (1988) have summarised the various approaches into three levels that are of more significance: system-centred, societal-centred and state-centred.

The system-centred approach, or international approach, is supported by quite a few influential theories which concentrate on the function of attributes or capabilities of one country relative to other nation states (Ikenberry et al., 1988), with government officials perceived as responding to particular sets of opportunities and constraints that a nation's position in the international system creates at any moment in time. The international system is a necessary "first cut" in any analysis of international or comparative politics, as well as being important in the study of foreign trade policy in a single nation state, as it is able to explain recurring international events and the commonalities in national foreign policies.

One of the most famous theories is that of hegemonic stability which holds that the existence of hegemonic power is a necessary condition for the existence of international transactions. Gilpin (2001) states that a hegemon possesses two dimensions of power: political and military strength as well as economic efficiency. With this power, the hegemon has the resources to force or induce others to adopt liberal practices in their foreign trade, thus being able to create and maintain a stable international economic order which decisively influences the other country to participate. Being considered to be subordinate to politics, economics is used to optimise the national interest that enables the state to take actions in order to achieve its goals of security, welfare and other societal values. Although economic welfare is pursued for its own sake, the ultimate objective is to be instrumental for political power. The analysis is thus focused on the power distribution among states within the international system, with international actions being regarded as product of global structure, defined by the

distribution of power and resources (Lipson and Cohen, 2002). By understanding a state's sources of strength and areas of vulnerability in relation to other states, a better understanding of the creation of foreign trade policy is consequently developed.

The hegemon theory has been primarily used to account for the role of the US in its creation and maintenance of an international trade regime, and in particular, to explain how the international economic order was established after World War II under US hegemony. In the case of international trade, it is used to explain why the US prefers to pursue bilateral free trade agreements in which it is able to benefit from an asymmetric power relationship in its favour, rather than multilateral arrangements (Bayne and Woolcock, 2007).

However, as the theory only identifies the international constraints placed on nation states without considering the domestic political process, it is limited to explaining recurrent patterns of behaviour within the international arena and is inadequate in explaining the foreign trade policy in a single country (Ikenberry et al., 1988). It also fails to describe how a free trade regime is established, maintained and abandoned, with Stein (1990) arguing that a hegemon can not alone bring about an open trading order without getting others' agreement. Trade liberalisation, therefore, among major trading states is rather the product of tariff bargaining, where the hegemon is likely to be required to make important concessions in order to achieve the political objectives (Stein, 1990). Another weakness, as identified by Woolcock (2007), is that it is hard to measure power in the case of international trade. He argues that since the whole trade regime is built on the concept of reciprocity, countries have been reluctant to liberalise their markets unless they have been confident that other countries want to do so in an equal measure. When the relative market size provides a fairly good proxy for power, which lends more leverage to negotiations, the challenge lies when negotiations are shaped by other elements of power, such as national security considerations.

Regime theory argues that states would only cooperate when there are cross border economic activities that require rules or norms of behaviour, such as transport and telecommunications (Woolcock, 2007). When applying the theory to analyse a nation's policy of international air transport, it can be used to explain why the two countries are willing to sit together with an attempt of striking an agreement with respect to

international operations between the country-pair market, due to the fact that the parties concerned are signatories to ICAO and are obliged to abide by the provisions of international conventions. However, it will not be appropriate to be used to explain why one party is willing to accept and agree what is requested and demanded by the other party, both of which are likely to have divergent agenda and objectives to achieve. One party is able to assert pressure for a more liberalised transport agreement but will find it hard to force the party at the other end of the country-pair market to accept what is proposed to its own benefit. When member states commit to binding obligations within ICAO's setting, they also limit the range of policy options open to them.

A second level of analysis is the society-centred approach. In contrast to the international level of analysis, emphasis is given to domestic politics either reflecting the preferences of the dominant group or class in society, or resulting from the struggle for influence that takes place among various interest groups or political parties. This approach views the policymaking process as a function of the interplay between organised societal interests and political institutions, thus resulting in government policy as being the outcome of a competitive struggle among affected groups for influence over particular policy decisions and the objectives being reflected in politicians' responses to different interest groups' demands (Bayne and Woolcock, 2007). Government institutions essentially provide a platform for group competition and do not exert a significant impact on the decisions that emerge (Ikenberry et al., 1988). This approach is widely applied to analyse the effects of interest groups on economic policymaking in the US, which are primarily concerned with maximising the economic welfare of the individuals they represent. For example, Dam (2001) observes that the US has constructed a political system with many points of access for interest groups and a number of elements to facilitate interest groups' influence. He further explains that one such element involves how the separation of power works to prevent a US President from taking action on international economic policy without the support or the explicit approval of Congress. Another point of access for interest groups is provided by the executive branch departmental structure, within which many departments and bureaus see their role in large measure as that of advocates for economic groups. With so many ways of influencing and places to access the policymakers, interest groups can frequently obtain favourable action, block unfavourable action, or redirect action by

manoeuvres in the congressional committee system or in the labyrinth of executive branch departments and bureaus.

However, this approach, as Dam (2001) notes, is not necessarily applicable to other non-democratic systems where there is no platform for interest groups to get their voices heard. It is also criticised for a lack of theoretical rigour as it lacks a mechanism to measure independently the weight of group power, thus creating problems when identifying the dominant group or coalition at any time (Ikenberry et al., 1988).

In terms of international air transport, this approach is useful in analysing how different interest groups interact and how the outcome of the negotiation is influenced by those who either share common interests or hold competing views. Even within one industry, corporations of different sizes and business models tend to have divergent interests which all require satisfying by the policymakers, who are supposed to be open and unbiased in assessing the different views. This, in turn, has an impact on the negotiation outcome regarding to what extent a more liberalised air transport arrangement should be agreed upon, and whether protectionist measures should be in place to safeguard domestic businesses and markets. However, in applying this approach to international air transport, it should be noted that interest groups operate differently in different social systems. In countries like China with a non-democratic regime, representation of interests groups of the aviation industry is constrained by the system, whose approach of exerting impact on the policymaking process is, therefore, different from that in democratic countries such as the US.

A third level of analysis, state-centred explanation, stresses the significance of a state's institutional structure in shaping international trade policies (Baldwin, 1996). This approach has two focuses: one is to perceive the state primarily as an organisational structure, or a set of laws and institutional arrangements shaped by previous events, while the other is to assume the state to be an actor, concentrating on politicians and civil servants whose behaviour is to respond to internal and external constraints in an effort to manipulate policy outcomes in accordance with their personal preferences (Ikenberry et al., 1988). The institution focus sees institutional change as nonlinear which occurs primarily at moments of significant crisis, while the individual focus argues that policymakers will intervene in the process in pursuit of objectives that are

determined independently from domestic interest groups' narrow self-interested concerns. Although the state is the basic actor in international relations, state action can be analysed most effectively by concentrating on the behaviour of those individuals with a determining impact on international policies whose responsibility is to act for the state (Edwards and Wayne, 2009). Personal power and behaviour is critical in determining the direction of a nation's international trade policymaking.

Borrowed from other academic fields such as psychology and sociology (Abe, 1999) in analysing the behaviour of politicians and civil servants, this approach also focuses on cultural, behavioural and psychological aspects of the individuals who are able to build new institutions to alter the distribution of power within government in order to achieve a specific goal, and are capable of mobilising inactive societal groups into the policy arena to offset their political adversaries while complementing their own interests (Ikenberry et al., 1988). Policymakers are shaped by ideas and beliefs and crafted by cultures where they are immersed. They have strong views on what constitutes a correct public policy and believe it is their duty to execute such policies, even in the face of contrary pressure from special interests (Zampetti, 2006). For example, the driving ideology of US foreign economic policy has been and remains the ideology of liberalism, advocating free trade and optimisation of personal benefits (Dumbrell, 1997). The importance of ideas is highlighted by Zampetti (2006) who argues that ideas are able to fulfil the constitutive function for international society as well as shape the identity of states, which inspires policymakers to communicate and persuade their international counterparts to agree to coordination and cooperation in a dynamic and ever-changing international environment, where the identification of national interests is increasingly difficult due to globalisation and interdependence.

However, Woolcock (2007) argues that the role of individuals in the twenty-first century's international economic activities should not be overestimated to such an extent that an individual has mastery of the issues to sway over negotiations, due to the large number of actors being involved and the complexity of the issues. The individual-focused approach is also under scrutiny as it fails to address the international environment, or the policy effect of foreign governments, international organisations and other foreign interest groups which have an impact on the considerations of

individual policymakers. When applying this approach to international air transport policymaking of a particular country, it can be argued that its bureaucratic system carries specific features which are unique to reflect its social and economic system, hence shaping the corporate culture that in turn has an impact on its employees. It can also be argued that officials working for the bureaucracies are subject to the influence of their personal background and experience. For example, the Civil Aviation Administration of China (CAAC) has developed out of a branch of the country's Air Force. Employees used to be quasi-military servants with military rankings who are characterised with obeying and following instructions. However, it is not convincing to assert that these officials working for CAAC are empowered to dictate the policy objectives and negotiation outcome without taking into account their concerns of the overarching national political objectives.

2.2.3 Need for a comprehensive analytical framework

Various approaches applied to the study of international trade policymaking have greatly contributed to the understanding of the formation of the subject matter (Baldwin, 1996). The economic model is very helpful in understanding certain types of economic policymaking behaviour but is inadequate for analysing the full range of economic policies in a nation state and for undertaking comparative studies across countries. Political scientists have helped to provide insights into some policy behaviour for which economic models are of little use, but failed to develop the subject from an all-embracing perspective allowing the examination of changes over time and across a country. Nevertheless, all approaches, no matter what their focuses are – international constraints, domestic determinants, or institutional and individual influences – can be more or less regarded as representing a single-level analysis (Zhao, 1996), all of which serve as the primary inputs leading to the formulation of the international economic policy as an output. By highlighting one attribute, Zhao (1996) argues that, a single-level approach is valuable in explaining one aspect of behaviour of the international policymaking, but fails to address other attributes which function simultaneously in this process. As a result of this sophistication, it is obvious that there is no single theory of any discipline that can provide definite answers on how states, under given circumstances, will conduct policy (Bayne and Woolcock, 2007). It remains challenging

for a researcher to decide how to underpin an analytical framework with the use of theories available to help identify the complex factors that shape the policymaking process.

Baldwin (1996), therefore, has called for a truly general framework to be developed which can be applied to the analysis so as to explain not only how the distribution of international economic and political power, domestic determinants, institutions, culture, values and ideologies contribute to affect a country's international trade policies, but also how a country's trade policies have changed over time. Odell (1990) emphasises the need for synthesizing the different approaches, noting that each of the models individually has proved inadequate as a single unifying vehicle. He, therefore, would welcome what he believes as an integrated theory of trade policy formulation emerging in a form that encompasses individuals, groups and states as actors. Bayne and Woolcock (2007) have called for an analytical framework in order to help sort out the complex factors that influence the complicated and sophisticated decision-making process and to identify the main explanatory factors so as to enable some generalisations to be made on the nature of trade policymaking.

Great efforts have been made in an attempt to synthesize the different models so that a linkage approach can be developed to allow all variables to be examined with the aim of gaining insight into the complicated nature of the subject matter for a comprehensive understanding and interpretation of the policymaking process. Baldwin (1996) has proposed a framework by bringing together the four major sets of actors he has identified whose interactions would determine a country's international trade policy, which include: home government; individual citizens; common interest groups; and foreign governments, along with various other foreign groups such as international organisations and other foreign interest organisations. Among these actors, he further explains, home government is the key participant in the process, since it makes the final policy decisions and implements the policies, while the other three actors, though they take action, only influences the nature of these decisions by exerting various forms of political pressure on the domestic government. He stresses that it is necessary to recognise the importance of these diverse factors as identified, each of which deserves full attention for a rigorous analysis and examination. He trusts that this framework

would avoid the drawbacks discussed in the preceding analysis, by “focusing on the maximizing behaviour of four major participants in the policy determination process”.

Baldwin (1996) further argues that an even broader framework is needed when international trade policies are being analysed in places and times with different political and economic institutions and ideologies from those that currently exists in the US, because the different regimes have different systems which will only work in certain circumstances. For example, the factor of common interest groups will have little or no influence on the officials in a non-democratic government who are not seeking election or re-election, while bureaucratic institutions and domestic political regimes are likely to outweigh the rest of the factors in deciding what the government wants to achieve through international economic activities. Although Baldwin proposes an analytical framework, he himself does not apply it to any empirical research.

2.3 Approaches applied to analysing Chinese foreign economic policy and behaviour

According to Hao and Su (2005), early studies of Chinese foreign policy are based on the state-centric assumption of a traditional realist approach to the study of international politics, treating policymaking as the product of a rational and unitary state that pursues and maximises its national interests under the constraints imposed by the external environment. This is because China is vulnerable to superpower dominance and manipulation, so that foreign policymaking is a reaction to such constraints, when the country tries to secure economic and development objectives as well as strategic interests (Tow, 1994). Hao and Su (2005) also assert that culture and ideology used to be the critical factors that craft the mindset of Chinese elite policymakers and the result of this situation is the country’s one-sided stance leaning towards one superpower in dealing with international issues. After the 1980s, as China’s policymaking became less personal, radical and ideological, the focus of study turned to policymaking structure, process and bureaucratic politics with an attempt to reveal the role of various domestic institutions and their interaction within the country’s foreign policymaking process (Hao and Su, 2005).

Since the 1990s, scholars studying China's foreign policy making have adopted a societal factor approach, exploring the roles played by various social forces in the process of policymaking. These factors include the domestic political system, bureaucratic politics, mass media, decentralised local governments and non-government players, which are all identified as internal sources in affecting policy formulation and change. Recognising the importance of domestic forces, this approach indicates that China's foreign policy is developed with the aim of addressing domestic pressures to reflect the concerns of the public. Interest group politics exists and plays in a different manner despite the country does not have a democratic system.

Researchers such as Zweig (2002) have examined the role of international environment and argued that China's foreign trade policy is a response to international pressures. For example, import quotas on China's textile exports under the Multi-Fibre Agreement and surplus capacity in the global shipbuilding industry forced China to reform both sectors, and in the case of textiles, to shift to higher value-added products (Zweig, 2002). However, Zweig (2002) has noted that an explanation solely relying on international structure and pressures is not sufficient, instead, domestic demand should be addressed which would help allow regulatory actions to be taken into account that facilitate the change. The analysis should be able to reflect the role of external forces, bureaucratic agents, domestic structure and a feedback loop based on the distributional consequences of internationalisation (Zweig, 2002).

The international-domestic linkage approach is adopted by Frieman (1994) who tries to understand China's foreign behaviour. She observes that the effects of the international system on Chinese foreign policy, citing international science and technology as an example, are really derivatives of its effects on domestic policy, with domestic policies being the driving force for the foreign policy, rather than vice versa. However, she explains that one could not simply categorise the set of international factors as "inputs", which, after being processed in China's policymaking machinery, would automatically lead to "outputs". This straightforward analysis only works to a limited degree and at a most general level. When making this calculation, one needs to appreciate how the machinery works to produce the "outputs". Examination of the full spectrum of implications for Chinese domestic policies should be pursued rather than looking for

cause and effect between the international arena and Chinese foreign policy (Frieman, 1994).

Analysis that integrates the factors at three levels has been conducted by scholars including Shambaugh (1994), Zhao (1996), Lampton (2001) and Ng-Quinn (2004) who examined China's foreign policymaking process. Shambaugh (1994) analyses the China-US relationship since 1949, exploring the patterns of interactions of factors at global, societal and governmental levels. He asserts that the three levels analysis is very useful for considering complex relationships and ordering of multiple factors, but not necessarily helpful in examining other issues on the bilateral agenda such as Taiwan. It is valuable to explore the broad dynamics and patterns of interaction between the two complex, ambivalent and contentious relationships. Lampton (2001) applies the three-level analysis on Sino-US relations between 1989 and 2000 which allows him to examine the impact of global institutions, domestic politics, mass media and individual elite leaders on China's policy towards the US. The approach enables him to depict a comprehensive picture of the Sino-US relations and how the two countries manage their relationship during that historical period of time, namely, after the June Fourth event and before China's entry to the WTO. Ng-Quinn (2004) analyses the role of Chinese culture, idiosyncrasy in determining the perception of Chinese leaders, domestic political conflicts, and the international system, which works collectively to shape the formulation of Chinese foreign policy. He argues that factors at all levels should not be treated as a laundry list without giving any item special or prioritised attention, as Chinese foreign policy behaviour is foremost influenced by the external constraints superimposed by the structure of the international system. All the rest – at domestic, societal and individual levels, including decision makers, domestic politics, as well as accidents, unintended consequences, coincidences, confusions, stupidity, etc – are only relevant to the extent that they cause changes in Chinese capabilities, leading to changes in the distribution of power, and thus, structural transformation.

Zhao (1996) termed his three-level analysis as a Micro-Macro Linkage Approach when analysing the country's foreign policymaking from 1949 to 1995. He explains that the terms micro and macro are completely relativistic, as what is macro at one level could be micro at another. He criticises that the various approaches adopted when examining

the Chinese case tend to underestimate or even ignore the interplay of micro and macro dynamics, or are not deep enough to investigate the micro level, thus failing to address the complexity of the policymaking process. “It is neither the macro-structure, nor the micro-decision-makers that have the absolute control over a country’s foreign policy, but rather the interaction of the factors at multiple levels that should be focused on in order to identify any causation, which includes international structure, domestic institutions such as national and provincial bureaucratic and social forces, as well as individual leaders” (Zhao, 1996). He asserts that his formula would enable the examination not only of the functions of the various factors systematically and collectively but also the correlations between them which affect the “black box” process of policymaking. The advantage of linking factors at both micro and macro levels is to avoid the shortcomings of one-sidedness that tends to outweigh certain factors at one level to the rest at another level.

Yet, attempts at theorising linkage politics seems to be abandoned because of the excessive complexities of the research object, with Abe (1999) observing that even analysing a state’s domestic politics is complicated enough. When attempts are made to integrate domestic politics with international politics, the task becomes hopelessly difficult (Abe, 1999).

Despite the efforts of trying to understand China’s foreign policymaking and its behaviour, it seems that scholars are quite frustrated with the best fit that can be applied to such endeavours. Kim (1994) points out that it seems to be just *prima facie* by simply fitting or transcending almost any theoretical framework to the Chinese case, as Chinese foreign policy behaviour is so multifarious and multi-principled. He continues that China’s growing engagement in the multiple games of international organisations only provides an empirical basis for discerning a dominant theoretical perspective, while its participatory role in the world economic system as a result of its economic power only adversely creates myriads of new linkages, new opportunities, and new pay-offs for global interaction, which in turn makes the task even more challenging. Local Chinese scholars seem dissatisfied with simply replicating Western theories and approaches to the analysis of China’s foreign policy and behaviour. Wang (1994) observes that achievements in integrating Western thinking and methodology with

Chinese research work have not seemed very impressive. To some extent, the splendour of Western theories get lost when one looks for their relevance to Chinese conditions, and what is worse is that Chinese scholars even see the harmful effects of applying Western theories in China due to the fact that Marxism-Leninism is depreciated, devalued and attacked, which leads to ideological hostility in their analysis (Wang, 1994).

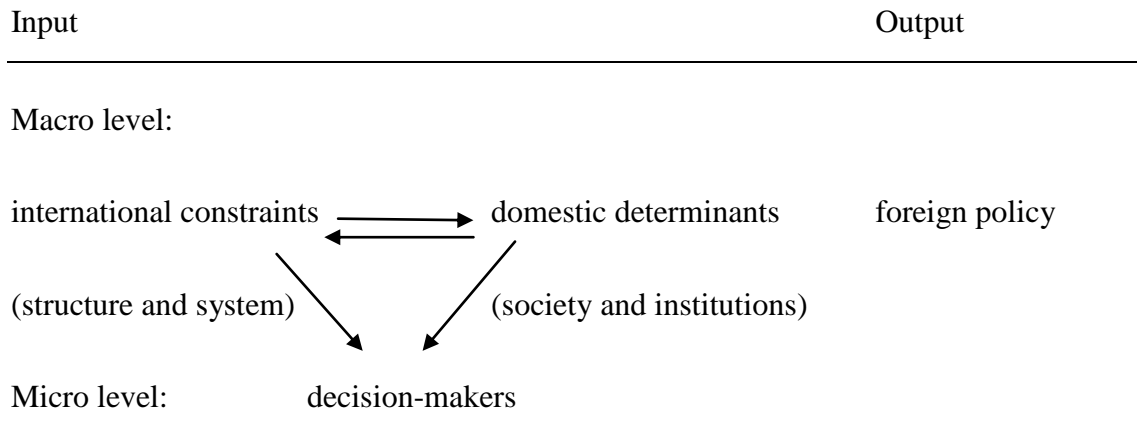
2.4 The Micro-Macro Linkage Approach

According to Zhao, the Micro-Macro Linkage Approach depicts a three-way interaction (Figure 2.1): while international constraints and domestic determinants are involved in a dynamic relationship at macro level, they also converge on, and receive feedback from, individual decision-makers (Zhao, 1996). In examining the cross-influences of influential elements at various levels by focusing on the processes, situations and structures of Chinese foreign policy, the key factors can be analysed extensively including the international environment, domestic sources and individual decision-makers which have a combined impact on the policymaking process. Specifically, the analysis can be conducted to examine the following:

- The channels and mechanisms through which demands from the international and domestic environments converge on the policymaking process;
- How the changing dynamics of domestic and international environments affect each other in shaping a country's external behaviour; and
- How they influence individual decision-makers in the formulation of foreign policy.

This linkage model appreciates the various influences and existence involved at each level without discriminating against any factors at any level that will have a role to play in the process, with all being considered in a relative sense (Zhao 1996). He argues that none of the elements will have an absolute control over a country's foreign policy, the complexity of which can only be understood by looking into the mutual influences, channels and mechanisms, between and among them, at both micro and macro levels.

Figure 2.1 The Micro-Macro Linkage Approach.



Source: Zhao (1996)

Applying this framework, Zhao (1996) has discussed the fundamental changes in China's foreign policy since 1949. He examines China's gradual shift from security issues to economic concerns, Beijing's interpretation of international and domestic environments, power transition from Mao to Deng, and the changes in rules, norms and mechanisms in China's policymaking process. As a demonstration, he applies his model to the case of Japan's official development assistance to China with an attempt to explain how both countries changed their views to agree on the assistance projects.

As a radically different starting point aimed at creating new research agendas for the study of Chinese foreign policy (Zhao, 1996), the effort is appreciated as an early attempt to bring theoretical rigour to the field of China studies (Whiting, 1994). Notwithstanding, his approach has since been little replicated or tested though his own study is regarded as opening a door to a new direction for future Chinese foreign policy studies. Zhao (1996) himself acknowledges that the challenge of the linkage approach is how to create theoretical concepts that are able to translate or map the factors at the individual level into factors characterising social systems, and vice versa. "The limit of the study is the insufficiency of empirical micro-level material to do a thorough application of this model, to fully cover the interactions between different levels with regard to foreign policy choices" (Zhao, 1996). He, therefore, has identified new areas and developed a few agendas for future research so as to test the framework, including "Bilateral Relations with Other Countries" and "Domestic Mood and Foreign Policy".

To facilitate further research, Zhao (1996) calls attention to the behaviour patterns and policy choices of Chinese foreign policy in the post-revolutionary era, which suggests that China is more likely to enlarge the degree and range of its participation in international activities. Its pursuit of economic modernisation and regional stability would incline China towards greater cooperation on security matters and increasing economic and cultural exchanges.

2.5 Applying the Micro-Macro Linkage Approach to China's international air transport policymaking

The preceding discussion has examined the various approaches applied to the analysis of China's foreign policymaking. Although it is undeniable that the gap in interpreting the subject matter has not yet been considerably narrowed (Wang, 1994) and there has always been a debate as to what is the most appropriate approach, significant achievements have been made in deepening the understanding of China's foreign policy and behaviour, thus narrowing the gap of theoretical knowledge and actual practice.

Unlike the rest of the world, China is unique in terms of its history, ideology, culture, constitution, bureaucracy and social system. Despite the fact that China has increasingly integrated into the global economic system, it still remains a socialist country with the Communist Party being its sole ruling party. This uniqueness presents the most dynamic case for study but also poses challenges which require a sound justification for the methodologies and theories when being applied to the Chinese case.

However, this uniqueness, as Rosenau (1994) argues, should not be an obstacle rejecting the applicability of general theory. Instead, to see China as different and acting out of unique historical and cultural circumstances, is to have a theory of the established and recurrent patterns from which China deviates, despite scholars holding divergent views as to which will be the best fit. Shambaugh (1994) calls for a need "for Western sinologists to escape their ethnocentrism and attempt to crawl inside the mindset of the Chinese elite and mass not at the cost of scholarly objectivity or universal standards of human rights". Hamrin (1994) requires the Chinese specialists to "find ways to integrate studies of domestic and international Chinese behaviour, of historical and contemporary studies, and of studies from different disciplines". The various sources, though likely

competing for the attention of the decision-makers, are all worth studying. These include ideological preferences, perceptions of China's national interest, assessment of China's material power, historical experience, political tradition and political culture, domestic structure and political attributes such as the changing political climate, and the composition of the leadership (Hsiung, 1980). Wang (1994) suggests a Sinocentric approach by calling for scholars to look at the study of Chinese politics and to gradually become better integrated with the rest of comparative politics, so that the research into Chinese characteristics would enrich comparative politics. Although admittedly there is no available method that provides a satisfactory and much less conclusive answer to the questions as to which approach provides a better fit with analytic needs (Whiting, 1994), China has to be placed in a larger theoretical context (Rosenau, 1994).

Although Zhao's approach is formulated to analyse China's foreign policymaking with no application to other industries to test its vigorousness, it is the intention of the researcher to apply it to analysing China's international trade policymaking, in this specific case, analysing its international air transport policymaking. The researcher acknowledges the challenge posed in applying the approach to the subject matter, as it is one of the first ever attempts in replicating the approach to the empirical research.

The rationale for such application is based on the following justifications:

- International air transport has long been considered as a political tool in China to support the country's diplomatic and political objectives. Before the 1970s, China had very few international routes, which only connected the country to its socialist allies. International air transport negotiation was used as a precursor to assure the stance of the foreign government to recognise one China policy. Bilateral agreement was regarded as one of the diplomatic instruments that facilitated the establishment of the official diplomatic ties with China. Such a political feature only started to fade in the 21st century after China joined the WTO, with the international air transport being categorized as service industry, and the government committing itself to removing trade barriers to promote liberalisation of free trade.

- Air transport policy, even today, still remains to be within the domain of China's overall foreign policy realm, with the responsible authority reporting to the MFA for policy guidance and the principles governing the bilateral negotiations. Considerations are primarily given to whether the air transport policy towards a specific nation state is corresponding to its overall foreign policy/diplomatic objectives and the relationship with the country.
- A third justification is that international air transport is governed by international regime, namely Chicago Convention. ICAO sets the rules and regulations that China has to abide by as a signatory member state. The approach would allow the researcher to examine the role played by international regimes and rules that China is obliged to. It will also enable the analysis of the bilateral relations between China and its counterpart to assess how this relationship affects the country's air transport policymaking.

In light of the above argument, while reflecting on the aim and objectives of the current research as specified in Chapter 1, this researcher is convinced that the Micro-Macro Linkage Approach will be the most appropriate for this research in that:

- It allows the examination of the factors at all levels and focuses on the interplays between them. In particular, the relativistic nature of the factors at all levels gives the researcher the capacity to examine how they co-relate with each other and affect each other.
- It allows the examination of the factors on a situational and case-contingent basis, which are different in terms of time, space and particular issues.
- It will be essential to interpret the causal relationships among various factors at different levels.

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Chapter 3 Research Methodology

Research methodology refers to the choices that are made with respect to the cases to be studied, and methods to collect and analyse data in planning and executing a research (Silverman, 2001). In order to achieve the aim and objectives of this research, namely to identify the factors influencing China's policymaking process with respect to international air transport and understand how the factors interplay with each other to affect the policy outcome, it is crucial to determine the most appropriate research methodology to ensure that the data and evidence collected are valid and that an unbiased analysis is conducted so that an objective presentation of the findings and conclusions is presented. This chapter, therefore, discusses such issues as the appropriateness of the research approach, research design, methods of data collection and analysis, and ethical concerns in conducting this research.

3.1 Research approach

Conventionally, there are two main types of investigation employed in the social sciences: qualitative and quantitative research (Gorman and Clayton, 1997). They share similarities but feature distinct differences. They are driven by the same philosophy in performing an empirical inquiry but emphasise the different nature, methods and analytical techniques of the data gathered. They both look at hypothesis testing and theory generation but employ divergent logics in this pursuit. They are both used for descriptive, exploratory, explanatory, hypothesis-testing, and theory-building purposes but highlight different routes to accomplish these tasks. Despite some of their common characteristics and less stark contrasts, the argument as to which is more superior and stronger never ends.

3.1.1 Advantages of the qualitative approach

Qualitative research, as defined by Gorman and Clayton (1997), "is a process of enquiry that draws data from the context in which events occur, in an attempt to describe these occurrences, as a means of determining the process in which events are embedded and the perspectives of those participating in the events, using inductions to derive possible explanations based on observed phenomena".

By drawing data from the context and environment in which events occur and focusing on social constructs that are complex and always evolving, making them less amenable to precise measurement or numerical interpretation, the qualitative approach enables the researcher to examine the occurrence and the change process over time. Without allowing the researcher to remain remote and detached from events, qualitative research invites the researcher to actually enter the context to collect first-hand information through the insights gained from personal experience, thus enabling the researcher to describe the observations about physical aspects of the behaviour, setting and other characteristics of the environment through language. It is the narrative and records of conversations that help inform the content of the happening, adding a richness and depth not otherwise available from other research approaches.

In addition, through the immersion in the entire activity, the qualitative approach allows the researcher to develop a fuller and richer understanding to reflect the process and to adjust to new issues and ideas in that process. The personal experience gained from participation helps the researcher to develop appreciation and respect towards the occurrence and process from the participants' perspective.

Whereas the qualitative researcher often uses an inductive approach to begin with and findings might contribute to the evolution of new theories (Easterby-Smith et al, 2002), the quantitative researcher usually relies on a deductive approach, starting with certain assumptions and hypotheses which need data to support or contradict them. The bottom-up approach of qualitative research to problems and issues allows complexities to be elucidated by those who are directly involved, rather than studied from a distance by remote researchers who may not be aware of the subtle nuances and hidden currents in a particular situation. Flexibility in the qualitative approach, with its interpretivist focus, permits a more comprehensive understanding of the complex, historically and culturally significant phenomena and the evolving social constructs.

3.1.2 Advantages of the quantitative approach

Quantitative research reflects the philosophy that any objects can be measured in numbers and figures, which can subsequently be analysed statistically to draw inferences, to identify general patterns and relationships, to test theories and to make

predictions (Ragin, 1994). In contrast to the qualitative approach, the quantitative approach, though showing interest in the context, focuses only on a few selected contextual factors that are believed to be important and relevant, which then are tested in a quasi-experimental environment. Tending to identify the variables, whose relationship can be analysed and measured mathematically, the quantitative approach is more concerned with the end result rather than the process itself. It enables the research to be conducted on a highly structured basis to facilitate replication and produce quantifiable observations to be analysed statistically (Saunders et al., 2000). In order to minimise the personal influence on the outcome, the researcher is required to remain detached from the events and is discouraged from entering the context as a player. The result is also presented via numbers and figures, through which the researcher endeavours looking for patterns in order to develop explanations for normative behaviour and causal relationships among variables (Gorman and Clayton, 1997).

The quantitative approach, as the dominant approach in the natural sciences where laws provide the basis explanation (Saunders et al., 2000), favours generality and parsimony, which uses as few factors as possible to explain as much as possible. It identifies the factors with the strongest correlation and pinpoints key causal factors to interpret the relationship between effects in order to predict their occurrence (Ragin, 1994). The strengths, as argued by Easterby-Smith et al (2002), are that they can provide wide coverage of the range of situations, with the statistically analysed results aggregated from large samples being of considerable relevance to policy-decisions. However, it can be inflexible, artificial and ineffective in understanding the processes or the significance that people tend to attach to the actions.

3.1.3 Criticisms of both approaches

Although both qualitative and quantitative approaches have strengths that are widely recognised, there is no shortage of criticism for both of them. Those who are against the qualitative approach are quite sceptical about the reliability of the data collected, interpreted and analysed, arguing that it is likely that the researcher might fail to note apparently trivial, but often crucial, activities which carry significance. A second criticism relates to how sound the explanations are. Bryman (1988) complained that “there is a tendency towards an anecdotal approach to the use of data in relation to

conclusions or explanations in qualitative research. Brief conversations, snippets from unstructured interviews...are used to provide evidence of a particular contention resulting in grounds for disquiet in that the representativeness or generality of these fragments is rarely addressed”.

Those who are not in favour of quantitative approach comment that “quantitative researchers who generalise from a sample survey to a larger population ignore the possible disparity between the discourse of actors about some topical issue and the way they respond to questions in a formal context” (Fielding and Fielding 1986), though some researchers are conscious of interpreting the statistical correlations in relation to what the variables involved mean to the participants (Silverman, 2001). There are certain areas of social reality, such as “attitudes”, that such statistics could not measure, and even though it can be measured, the pursuit of measurable phenomena can mean that unperceived values creep into research by simply taking on board highly problematic and unreliable concepts such as delinquency or intelligence (Silverman, 2001).

3.2 Rationale for using the qualitative approach for this research

While both qualitative and quantitative approaches have their respective advantages and disadvantages when being applied to research in social science, as revealed in the preceding discussions, there is no right or wrong answer as to which is better, but rather, which is more appropriate to enable the researcher to achieve the cited aim and objectives. The appropriateness of a research approach derives from the nature of the social phenomenon to be explored and the decision lies at the core of what type of research questions the researcher poses and what purposes the researcher wants to achieve (Yin, 2009). It should be borne in mind, though, that the research approach dictates how the data are collected, which, in turn, affect the findings and conclusions.

For example, the qualitative approach is frequently used for exploratory purposes, with the aim of developing preliminary and new ideas so as to devise refined questions for future research. By examining an issue or phenomenon that is only understood a little by society (Neuman, 2006), the “what” questions can be answered. Both qualitative and quantitative approaches, including surveys, field research and historical comparative

research, are applied in descriptive research, which aims at describing the process of what is happening so as to present a picture of the specific details of a situation, social setting or a relationship, answering the “how” and “who” questions. Both are also employed to either test a hypothesis or develop a novel explanation with empirical evidence in the explanatory research, with the main purpose being to try to identify the reasons “why” events occur (Neuman, 2006). The qualitative approach is commonly used in management and business studies, where there is a need to discover the details of a situation so as to understand the reality, or perhaps the reality uncovered, though the researcher needs to be mindful of the longer time taken and difficulty in controlling the pace and progress of the work (Saunders et al., 2000).

Reflecting the aim and objectives of this research, which is articulated in Chapter 1 as trying to identify the factors and determine how they interact with each other in China’s policymaking process with respect to its international air transport, namely to examine the process and answer the “who”, “how” and “what” questions to achieve the research aim and objective, it is believed that the employment of qualitative approach to collect data is more appropriate. It enables the researcher to apply all techniques available such as interviews, observations and case study to collect data and to crawl into the mindset of those who are personally involved in the process in analysing the data, with an attempt to understand the event from the participants’ perspective and to examine the scene uncovered.

3.3 The case study strategy

A case study is an application of specific qualitative research methods in a specific setting (Gorman and Clayton, 1997). It aims to preserve and understand the wholeness and unity of the case in depth, in its natural setting, and to recognise its complexity and context (Punch, 2005). With a holistic focus, the case study is considered more a strategy than a method or a specific technique (Punch, 2005).

A case study, as described by Gorman and Clayton (1997), is “an in-depth investigation of a discrete entity (which may be a single setting, subject, collection or event) on the assumption that it is possible to derive knowledge of the wider phenomenon from intensive investigation of a specific instance or case”. Yin (2009) sees a case study as

“an empirical inquiry that investigates a contemporary phenomenon in depth and within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident”. He further elaborates that “the case study inquiry opens with the technically distinctive situation in which there will be many more variables of interest than data points; relies on multiple sources of evidence, with data needing to converge in a triangulating fashion; and benefits from the prior development of theoretical propositions to guide data collection and analysis”.

A case study consists of a detailed investigation with data collected over a period of time within the context, with the aim of providing an analysis of the context and process which illuminates the theoretical issues being studied (Hartley, 2006). It is particularly suited to research questions which require a detailed understanding of a social or organisational process because of the rich data collected in context. As Yin (2009) points out, it is the ability to deal with a full variety of evidence such as documents, artefacts, interviews and observations, beyond what might be available in a conventional historical study, that is the unique strength of the case study to be able to serve the purposes of the researcher who attempts to investigate a particular event to answer the questions of “how” and “why”. Due to its down-to-earth and attention-holding features (Stake, 2000), it is widely used in organisational studies and across the social sciences, including organisational psychology, employment relations, sociology, business and marketing and political science (Hartley, 2006). It is especially preferred when examining contemporary events in which the relevant behaviours can not be manipulated to allow the researcher to retain the holistic and meaningful characteristics of real-life events (Yin, 2009).

3.4 Concerns about the case study strategy

Although a case study is regarded as a distinctive form of empirical inquiry, a series of methodological issues arise when considering the different purposes and nature of the case study, which have been the subject matter of considerable debate (Hammersley and Gomm, 2000). A case study is also complicated when too many “variables” are to be observed and analysed in the context which is designed and integrated into the case, where the application of standard experimental or survey designs and the criteria of data collection and analysis are not appropriate (Hartley, 2006).

3.4.1 Ability to generalise

The biggest concern is that the case study provides little basis for scientific generalisation, contrary to the quantitative approach with the ability of generalising findings to diverse populations and time (Smith, 1975). This is because, as Schofield (2000) observes, some researchers actively reject generalisability as a goal or give it a very low priority, seeing it as essentially irrelevant to the research goals. He attributes this historical attitude to the close link to cultural anthropology, with its emphasis on the study of exotic cultures. Another situation where generalisation should not necessarily be the objective of the research is that the case being studied is either “so unique in many important respects” that the intention of the study is to understand the case in its complexity and entirety, or is “negative” so that the main aim is to understand the typical by studying the atypical (Punch, 2005).

Since the 1980s, when the interest in the issue of generalisability increased markedly for researchers, the belief has been challenged. Lincoln and Guba (2000) criticise the concept of generalisation by pointing out that it suffers from a number of deficiencies such as dependence on the assumption of determinism and of freedom from time and space. They argue that no human activity is context-free, and many conditions, contingencies and disjunctions must be taken into account in undertaking any case studies, as local conditions deserve proper weight. They assert that any generalisation is a working hypothesis rather than a conclusion; therefore, there is no true generalisation due to the constant flux characteristics of the conditions and circumstances of the event.

Other scholars attempt to work out solutions to remedy the flaws. For example, Stake (2000) identifies another type of generalisation, “naturalistic generalisation”, which could be arrived at by recognising the similarities of objects and issues in and out of context and by sensing the natural co-variations of happenings. He assumes that readers would establish the basis for naturalistic generalisation, which develops within a person as a product of experience and is derived from the tacit knowledge gained from personal experience when this person recognises the essential similarities to the cases of interest.

Schofield (2000) suggests that potential generalisability can be enhanced when qualitative researchers design their case studies strategically, by choosing to “study the

typical”, to “study the leading edge of change and to probe factors likely to differentiate the present from the future”, and to “select a site that sheds light on what could be and attempt to generalise from an unusual site to more typical ones”. He points out that generalisability, in the sense of producing laws that apply universally, should not be a useful standard or goal for qualitative research, as it is vital to have wide descriptions of the site in which the studies are conducted and to which one wishes to generalise, as this allows the researcher to seek the similarities and differences between the situations.

Punch (2005) suggests two ways of generalising results based on the purposes of case study and on how data are analysed. One is by conceptualising where the researcher develops one or more new concepts to explain some aspect of what has been studied. The second is by developing propositions where the researcher puts forward hypotheses to link concepts or factors within the case, which are then assessed for their applicability and transferability to other situations. When generalisability is the goal of the case study, potential common elements should be the focus with analysis of the data being conducted at a sufficient level of abstraction, hence raising the analysis above a simple description to contribute to potentially generalisable findings (Punch, 2005).

Distinguishing analytical generalisation from statistical generalisation, Yin (2009) points out that the fatal flaw in doing a case study is to perceive statistical generalisation as the method of generalising the results of case study, which essentially is very generalisable to theoretical propositions, though not to populations or universes. He argues that the goal of case study is not to conduct a particularising analysis to enumerate frequencies, which is actually statistical generalisation, but rather to expand and generalise theories, which is analytical generalisation, and this can be achieved by taking a multiple case study approach. Choosing multiple cases for study resembles selecting multiple experiments by a laboratory investigator; hence, replication and generalisation may be claimed when two or more cases are shown to support the same theory (Yin 2009). In so doing, “you aim toward analytic generalisation and avoid thinking in confusing terms such as the sample of cases or small sample size of cases” (Yin, 2009).

Hartley (2006) takes this argument further by reiterating that theoretical orientation should be the key to case study research. He points out that “although case study may

begin with only rudimentary theory or a preliminary framework, the researcher needs to develop theoretical frameworks during the course of the research, which inform and make sense of the data and can be systematically examined during the case study for plausibility”. He continues that “the theory needs to provide not only a sense of the particular circumstances of the case but also what is of more general relevance and interest”. It is this theory development process which occurs through the systematic piecing together of detailed evidence that generates or replicates theories of broader interest (Hartley, 2006).

3.4.2 Reliability and validity

Although the criteria of reliability and validity are used more to justify the results of quantitative research (Marshall and Rossman, 1989), they are equally important considerations in a case study, though sometimes different terms and principles are applied (Neuman, 2006). Reliability means dependability or consistency, where the researcher endeavours to produce a consistent result over time, in either the same or different circumstances. This is quite challenging for case study which emphasises the change or developing process of the subject matter as the key value (Neuman, 2006). The key issue here is to understand that the goal of reliability is to minimise the errors and biases in a study. Reliability can thus be achieved by a later investigator following the same procedures as described by an earlier investigator and conducting the same case study all over again, and who then arrives at the same findings and conclusions (Yin, 2009). In so doing, it requires the researcher to document the procedures.

Validity is linked to “truth”, or the degree to which the researcher is given a true picture of the phenomena being studied. Case study researchers are more interested in authenticity than in the idea of a single version of truth, which means giving a fair, honest and balanced account of social life from an objective perspective. Validity includes construct validity, internal validity and external validity (Yin, 2009).

Construct validity refers to identifying correct operational measures for the concepts being studied. This is especially challenging in case study as critics point out that case study researcher fails to develop a sufficiently operational set of measures but uses subjective judgements to collect data (Yin, 2009). Internal validity in case study

extends to the broader problem of making inferences, since a case study researcher will always infer that a particular event is the consequence of some earlier occurrence based on information gathered by various methods. How can a case study researcher be so certain that such inference is correct to justify that evidence available supports such a correct inference? External validity deals with the problem of knowing whether the findings of a case study can be generalised beyond the immediate case study.

These concerns can be addressed in the phases of data collection and analysis. At the stage of data collection, triangulation of data collected from various sources will help to create the weight of evidence and enhance the impact of those ordinary and trivial empirical data out of which validity and reliability arise (Neuman, 2006). A case study database can be established to be referred to during the process of the research in order to improve reliability. At the analysis stage, Yin (2009) suggests that pattern matching, explanation building and logic models can be used to enhance validity, while Silverman (2001) suggests that reliability can be improved by writing notes on the texts and by comparing analysis of the same data by different researchers.

3.4.3 Triangulation

One of the key principles in data collection is to use as many different sources of evidence as possible, rather than a single individual source, with the purpose being to triangulate the data collected to enable the researcher to address different aspects of the same research question, thereby extending the breadth of the project (Gorman and Clayton, 1997). Stake (1995) terms this as methodological triangulation, which encourages a researcher to use different methods to collect the same information. By employing different methods with different paradigms (positive and interpretivist), the researcher is able to compensate for inherent weaknesses in each approach. For example, a review of old records can be followed by direct observation and interviews to verify what has been documented in the records. Interviews allow the researcher to have a detailed understanding of the perspectives of those involved in events, although it is vulnerable to the criticism of tending to limit the scope of the data collection process, resulting in a micro-level perspective. By triangulating the information from other sources such as documents and observation, the researcher is able to draw on the unique strengths of each method, thus providing both macro- and micro-level

perspectives in a single study (Gorman and Clayton, 1997). Triangulation also allows the investigator to address a broader range of historical and behavioural issues and develop converging lines of inquiry to support the findings and conclusions which are likely to be more convincing and accurate (Yin, 2009).

The process of triangulating and corroborating evidence and information enables the researcher to optimise the possibility of valid and reliable data, leading to objective analysis and findings, which enhances the credibility of the research. However, one has to accept that it is a very time-consuming, expensive and demanding job to gather information from different sources as it necessitates the investigator to master the various skills needed, to have good contacts who are the sources and able to provide more sources for data collection, to be able to cope with stress, pressure and ethical issues, and to manage time and resources effectively.

3.5 Rationale for applying case study strategy to this research

Despite the limitations of a case study strategy, it is widely used across the social sciences, including international relations, international economic relations and government policymaking, to fulfil various research objectives and help build up a comprehensive understanding of complex social behaviour. In examining organisational behaviour, case study is very useful in illuminating behaviour which may only be fully understood in the context of the wider forces operating within or upon an organisation. It is also useful in capturing the emergent and changing properties of life in organisations (Hartley, 2006).

One of the showcases is the explanatory, single case study project in political science, conducted by Graham Allison in 1971, which investigated the confrontation between the US and the Soviet Union in the 1962 Cuban missile crisis. Applying three competing but also complementary theories, the study followed the actual course of events, exploring why the Soviet Union placed offensive missiles in Cuba, why the US responded to the missile deployment with a blockade and why the Soviet Union eventually withdrew the missiles (Allison and Zelikow, 1999).

Another example includes Abe's (1999) examination into two cases – the automobile industry and the machine tools industry in Japan and the European Commission (EC) between 1985 and 1995 – to reflect the political and economic relations between the two economies. He analysed Japan's international economic policymaking mechanism by looking into the two selected industries focusing in the European Union (EU) market and explained why a trade deficit was caused (Abe, 1999).

Hooks (1990) employed a case study strategy to test a Policy-Oriented theory by examining the aeronautics and microelectronics industries of Japan between the 1970s and 1980s. The aim of the research was to attempt to understand to what extent the role of central planning and support from the central government had contributed to Japan's prominence in the world market, which was considered to be unfair, compared with the policies in other countries. By analysing and comparing the two industries, Hooks demonstrated how the Japanese defence department supported the early development of both industries. The two-case approach made the entire argument powerful and persuasive (Yin, 2009).

Zeng (2004) chose the trade conflict regarding semiconductors between the US and Japan and the negotiation between the US and China over Most-Favoured-Nation (MFN) status and Market Access as two cases to examine whether the traditional realist theory, with its emphasis on nations' underlying raw power balances, could help to explain the situation that the US encountered in addressing trade disputes with its foreign partners. Despite exhorting Section 301 of American trade law, the US failed to exercise its pressure on its trade partners to settle disputes to its preference. She concluded that it was necessary to look for factors other than raw power to understand variations in the effectiveness of America's pressure tactics (Zeng, 2004).

The above examples have demonstrated that case study is a rigorous strategy commonly employed to look into contemporary occurrences to enable an understanding of how behaviour and/or a process is influenced by, and influence context. The ability to use both quantitative and qualitative techniques to collect data allows a researcher to examine complex phenomena in their pursuit of the delicate and intricate interactions and processes occurring within organisations to fulfil their research objectives. Case study is also unique in allowing a researcher to examine the subject matter in a

longitudinal context. This means that the researcher can collect time series data over periods of time significantly longer than the immediate focus, thus focusing on the changing process within a broader social, economic and political context to enable explanations to emerge from examining patterns in the process (Easterby-Smith et al, 2002).

Reflecting the aim and objectives of the current research, with one of the objectives being to examine the evolutionary process of China's liberalisation policy with respect to international air transport in order to understand why China adopts its unique approach towards the market liberalisation and how China has attempted to achieve its objectives over the last three decades, the "why" and "how" questions, it is believed that case study is the most appropriate research method to answer those questions in this research. It will allow the researcher to investigate the behaviour of the organisations involved in China's international air transport policymaking process, and to identify what are the factors, both internally and externally, that affect the behaviour of the organisations. It will also enable the researcher to examine and analyse how these factors have been interacting with each other and evolving over the last three decades. It is hoped that a detailed examination of China's policymaking process and the changes over time will shed light on the understanding of China's international trade policymaking as reflected by its international air transport industry, hence contributing to the studies of China.

3.6 Research design

Research design is critical in preparing case study, as it is a blueprint to guide the researcher to determine what case or cases are selected for study and to ensure the right data are collected, properly analysed and interpreted in the whole process of the research. It is, therefore, important to discuss the rationale of case selection, data collection and analysis, following the guidelines identified in the preceding discussions.

Schofield (2000) suggests that a typical case(s) should be selected for study and how it fits a typical situation is far preferable to convenience or ease of access. Researchers should try to select a case that is typical of its kind based on the principle of typicality, which is more likely to enhance the potential generalisability of the research, while

bearing in mind that a typical example may not necessarily be typical in all important regards (Schofield, 2000).

Another principle to follow is to select multiple cases for study, as the evidence from multiple cases is often considered more compelling and the overall study more robust, although it could be more expensive and time-consuming. When selecting multiple cases, a rule of thumb is that each case must be carefully justified so that it either (a) predicts similar results for a literal replication or (b) predicts contrasting results but for anticipatable reasons for a theoretical replication (Yin 2009). In terms of the number of cases regarded as sufficient to support replication, two to three will suffice to ensure a better chance of having a good research project than just one, particularly when the theory is straightforward (Yin 2009).

In light of the above guidelines, this research selects three cases, namely three country-pair markets, for an in-depth analysis, which are the China-US market, China-the UK market and China-the Netherlands market. All cases are chosen with the firm belief that they represent typical markets, which is more likely to withdraw and improve the generalisability of the case study. Examining and comparing the similarities and differences of China's policy towards these economies will cross-check the factors identified that have an impact on China's policymaking process. It will help the researcher, hence those interested in China's policymaking, to gain insight on how different factors at different levels and different times interact with each other, leading to different policy results and arrangements for different country-pair markets. It is also believed that a comprehensive analysis of China's policy changes for different country-pair markets over the longitudinal context will help those interested public to identify the change pattern for future policy development. It will also help to identify if there is any element among these driving forces that has played a more critical role in shaping the policy changes and whether the same element carries identical weight in shaping that change in different context.

3.6.1 Rationale for choosing the three country-pair markets

International air transport is governed by the Chicago Convention which advocates that sovereign governments negotiate the air transport agreements between two countries

based on reciprocal principles. The Bermuda models set a template for bilateral regime governing the operations of international air transport. The Open Skies arrangements, though removing economic restrictions regulating the international air transport, are still concluded on a country-pair basis. Any operations involving a third country have to be agreed and permitted by the government concerned.

As a consequence, the study of the liberalisation policy of one nation will have to start from an examination of that nation's policy towards the nation at the other end of the country-pair market. This means that China's international air transport policy is reflected in its policy towards another country with which it negotiates for an agreement. Due to the different social, political and economic systems between nations, especially the divergent market conditions, the policy with respect to each country-pair market can be either identical or different to reflect the essential features of the bilateral markets. It is the array of these bilateral arrangements derived from continuous negotiations that reflect a nation's overall policy and policy change with respect to international air transport. In light of the above considerations, it is regarded as more appropriate to study the policies concerning a country-pair market that exemplifies and represents a nation's overall international air transport policy.

3.6.2 Rationale for choosing China-US market as a case

China is a statist, socialist developmental, late industrialising, and post isolationist country (Ryan, 1995). It is the largest emerging market in the world. As the most populated country with more than 50 ethnic nationalities occupying a vast landscape, air transport has played a key role in its political and economic objectives. Since 1978 when China started its economic reform, its economy has been growing at an average rate of more than 10 percent, making itself the second largest economy of the world in 2008, just behind the US (www.caac.gov.cn). Its air transport industry has responded to its phenomenal economic growth, recording an average 17 percent growth too (www.caac.gov.cn). IATA predicts that China, together with India, will shape the world air transport market in the 21st century thanks to their economic prospect (www.iata.org). Although international air transport plays a crucial role in facilitating the country to integrate into the global economic system, China is still undergoing the process towards full liberalisation. While acknowledging liberalisation as an irreversible

trend towards a truly free and efficient global air transport industry, China has been cautious in removing the constraints on its domestic and international air transport markets, with an aim of achieving a progressive, safeguarded and healthy growth of the industry. As its rising power in the Asia Pacific region will allow it to exploit its economic power to stand firm and counter any threats, Chinese policymakers appear intent on taking steps to enhance further their bargaining leverage in international trade diplomacy (Ryan, 1995).

The US is a pluralist, liberal regulatory, industrialised and highly economically diversified, and hegemonic country (Ryan, 1995). It is the first country to have deregulated its domestic air transport market. It is also the pioneer, and a driving force, in promoting the liberalisation of international air transport through its “Open Skies” initiatives. Since 1978, the “beggar-thy-neighbour” (Button, 2004) tactics in implementing its Open Skies initiatives throughout the world has reshaped the global air transport industry, not only in terms of its operational practice, but also its business models. Network airlines have adopted various strategies with the aim of expanding globally, while low cost carriers (LCCs) have radically changed people’s perception towards air travel. The US airlines such as United Airlines (United), American Airlines (American), Southwest Airlines (Southwest) and FedEx Corporation (FedEx) have become the most competitive businesses in the world. Being innovative in its management and operations, the US air transport industry will continue to have a major impact on the development of the industry on a global scale. It not only carries the typicality of the industry in every aspect but also embraces all the particularities of the industry. Its hegemonic power, in terms of politics and trade, will enable it to negotiate an agreement much closer to its preferences than to its counterpart’s (Ryan, 1995).

Politically, the Sino-US relationship is asymmetric as both approach each other in very strong positions relative to other countries in the typical “billiard ball” conception of international anarchy (Liu, 2004). The US is the only hegemon that is capable of promoting its own political and economic policies to the rest of the world which will shape the world order, while China, with its economic achievements over the last three decades, is assuming greater prominence in world affairs. The US as a global power and China as a regional power are in similar situations in that each must relate to countries

that in general are smaller in terms of population and economic capacity (Liu, 2004). The US holds China as its strategic partner, which has overtaken Japan to become its second largest economic partner, while China treats the US as its critically important strategic counterpart, recognising the US unitary power in the world. Harding and Frankel (2004) asserts that the benefits of the Sino-US relationship would be so great and the costs of failure so large that the two countries should make every effort to maintain the momentum towards building a constructive strategic partnership.

Economically, despite the ups and downs of the political relationship, the two have become closer and more interdependent. According to the statistics of the Department of Transport (DoT), traded goods between China and the US were just US\$18 billion in 1989, with China being the tenth largest trading partner of the US. By 1999, however, the value of traded goods had reached US\$94.40 billion. After China's accession to the WTO in late 2001, and as a result of its commitment to reducing import barriers, bilateral trade increased by an average of 23 percent per annum between 2001 and 2006, with the total value of US imported goods from China rising to US\$343 billion. China, thus, became the second largest trading partner of the US after Canada. Between 1989 and 2006, the value of US imports from China increased by 2,300 percent and US exports to China by 851 percent (www.dot.gov). In 2008, the US arrivals in China reached 1.78 million, 1.25 million of whom arrived by air. This compared with around 493,000 Chinese citizens having visited the US, who spent US\$2.6 million in the process (www.dot.gov, www.cnta.gov.cn). The increase in trade of both goods and services has stimulated the bilateral air transport markets, which connect the world's two largest economies. In 1989, there were only 878,000 air passengers travelling between the two countries, while by 2001, the designated airlines of both sides carried 1.3 million passengers in total. By 2008 the figure had increased to 2.4 million (www.dot.gov). According to Airport Council International (ACI) (www.aci.org), the US carried a total of 1.45 billion passengers and 29.3 million tons of goods, making it the world's largest air transport market, followed by China which carried 350 million passengers and 11 million tons of goods.

It is anticipated that by the year 2025, seven of the world's ten largest economies will be located in Asia, with China undoubtedly leading these upwardly mobile states due to its

size and the speed of growth (Chan, 2008). Accordingly, the emerging importance of the Asia Pacific region, and especially the rise of China's rank among these unfolding processes, has the potential to bring about a fundamental transformation of the global political economy. "Whether for good or ill, the most significant bilateral international relationship over the course of the next several decades is likely to be that between the US and China", as Chan (2008) observed.

Most Sino-US relationship studies are focused on the military, general trade disputes, political and strategic aspects (Robinson, 1994; Shambaugh, 1994; Ryan, 1995; Cheung, 1998; Suettinger, 2003; Zeng, 2004; Hao and Su, 2005), while air transport, however, has not received much attention, which is an integral part of the bilateral political and economic relations and exemplifies the status of the bilateral relations. To fill in this knowledge gap, this study chooses to analyse the Sino-US air transport market by focusing on the Chinese approach towards liberalisation of the Sino-US market. Such an approach will not only enable the researcher to examine the Chinese view towards opening up its sovereign sky to allow more international flights into its space, but also exemplifies China's overall trade policy towards America. Taking all the above into account, the study of China's policy on the Sino-US market will be the best showcase of China's approach towards liberalisation through the bilateral mechanism, and serve as the most typical case for studying the country's international air transport policy, which will, in turn, reflect China's international trade policymaking approach.

3.6.3 Rationale for choosing China-the Netherlands and China-the UK as two cases

Both the Netherlands and the UK are EU Member States. The EU represents the most diversified air transport market in the world. Though following suit in liberalising its air transport market, the EU achieved this objective through regulations issued by a supranational body created by its own Member States. Being the first intra continental market where true air transport liberalisation has been realised, the EU has shaken the fundamentals of the Chicago Convention, which has been governing the operations of international air transport since 1944. A nationality clause is no longer the restriction that prevents the establishment of air carriers within the EU. Furthermore, with the mandate authorised by the European Council of Transport Ministers, the European

Commission (EC), representing all EU Member States, has been negotiating with third countries for a horizontal air transport agreement to amend the nationality clause, one of the most prominent being the “Open Skies Stage I and II with the US concluded in 2007 and 2010 respectively.

Although China has been identified as one of the strategic targets for the EC to accomplish the “Open Skies” negotiations, EC until 2010 had failed to obtain the mandate from the European Council of Transport Ministers to be authorised to negotiate on behalf of all EU Member States (Geil, 2010). On the other hand, China has been cautious about the EC’s approach, as China is concerned about the abuse of designation of carriers eligible for operations under the EC law but not necessarily acceptable for China due to the fact the China has not yet concluded bilateral ASAs with all of the 25 EU Member States by the end of 2010 (Liang, 2010). Under the current arrangement, each EU Member State is entitled to negotiate with China individually, with the outcome of the discussions and agreement concluded being submitted to EC for approval and record (Geil, 2010).

Though small, the Netherlands claims to be the hub of transport and logistics for western and central Europe. Being innovative in business and strategy, the Netherlands is the first country that signed “Open Skies” with the US in 1992, which was a landmark in ushering the international air transport industry into a new era. The Netherlands started its aviation relationship with China in 1993 and is one of the few EU Member States that China has agreed to accept the nationality and designation clauses in the revised ASA which is required to be in conformity with the EU law (Liang, 2010). The agreement will have a significant impact on the future negotiations as it will serve as a model for both parties to address the issues with respect to nationality and designation clauses, and hopefully pave the way for a China-EU arrangement.

The UK, an island off the European continent, has had a complicated relationship with China due to its close link with Hong Kong, which used to be its colony before 1997. Although the two parties started their air transport relationship in the 1950s, the arrangements between each other are still somewhat restrictive in terms of designation, capacity and pricing, which to some extent does not reflect the increasing bilateral trade over the years. As one of the first EU Member States that liberalised its domestic air

transport market and played a key role in pushing forward the liberalisation within the EU, the China-UK market apparently is left behind in terms of governmental arrangements.

As an economic entity composed of a large number of countries with their economic development at different stages, the EU has demonstrated a strong single voice in addressing its international relations and gained more power in the world's political arena. Its capability to influence the world's political agenda is getting increasingly stronger. Both the Netherlands and UK are chosen for this research because of their unique position with the EU and their influencing power with the EU.

As China is getting prepared to negotiate with EU some time in 2011 for a China-EU air transport arrangement (Geil, 2010), it would be significant to examine China's view towards two of the most important Member States within the EU with respect to international air transport. The study of these two markets will, to a great extent, reflect China's view toward a multilateral approach to liberalising its international air transport industry.

3.7 Data collection

To optimise the strengths of data collection methods available for case study, the data for this research will be collected mainly through qualitative techniques, including interviews, analysis of documentation and archival records, and observation (Yin, 2009). Interviews are actively created data which only exist with the involvement and intervention of the researcher, while documents, archives and observation exist independently without involving the activities of the researcher (Silverman, 2001). They provide both rich sources for data collection and corroboration to enable an objective analysis.

3.7.1 Interviews

The interview, one of the main data collection tools used in case study, is an effective way of ascertaining people's perceptions, meanings, definitions of situations and constructions of reality, which are the key to helping understand the case from the perspectives of those involved. For this research, around 20 interviews are conducted

with interviewees identified as important and critical in providing the information required. The interviewees include government officials who have been involved in the bilateral ASA negotiations, diplomatic officials involved in facilitating bilateral communications, local government officials responsible for facilitating air transport planning and development, airlines executives participating in the negotiations, airport managers responsible for international route development, and academic peers whose expertise is in aviation and international relations research.

Preparation work has been conducted before the interview. The interviewees are approached via email and telephone to be briefed with the objectives of the research and rationale of the interview. Questions are prepared following the literature review and discussions with the supervisors, who provided invaluable advice and comments, which has ensured that the questions are able to facilitate probing for the perceptions of the interviewees and the occurrence of the negotiations. The questionnaires are then sent over prior to the actual interview date, which is confirmed by telephone and email communications. Further background information is channelled to allow the interviewees to evaluate whether they want to participate or not, and instructions given in order to prepare the interviewee for the session. These questionnaires with different questions targeting at different people for different information received very well response, which not only supplied the information but provided significant insight to help the researcher to understand the context.

In-depth and face-to-face interviews, as well as informal conversational interviews, have been conducted at various sites and stages with the following organisations which include the US Embassy in Beijing, CAAC, Northwest Airline China office, the European Commission, Traffic Management Office of Hainan Provincial Government, Ministry of Infrastructure and Environment of the Netherlands, KLM Royal Airlines (KLM), Amsterdam Airport, Airneth, University of Leiden, Beijing Capital International Airport (BCIA), China Eastern Airlines (MU), China Hainan Airlines (HU), Air China (CA), and Guangzhou Baiyun International Airport. Face-to-face interviews have been conducted in the interviewees' offices, where an atmosphere conducive to open and undistorted communication (Silverman, 2001) is created so that the respondents would feel comfortable and relaxed. The researcher has been careful to

manage the relationship with the interviewees to make sure that equality and a friendly atmosphere has been maintained (McQueen and Knussen, 2000). Each interview lasts for a minimum of one hour to a maximum of 4 hours depending on the subject matter discussed. Some interviewees are interviewed several times for the purpose of clarifying information gathered or exploring for more details. During the interview, body language is observed, notes taken and recording facilities used with the permission of the interviewees. Attentive, reflective listening is given to the interviewees and queries raised. Clarification is then pursued to reflect the conversation and to confirm an appropriate understanding of the replies to the questions. Follow-up telephone calls are made for further clarification and verification. Informal conversations are also conducted in interviewees' offices with the intention of minimising any unnecessary misunderstanding about the objectives of the research. These intimate and casual communications have produced very useful information in the circumstances where officially asked questions might have caused concerns or worries for the interviewees.

Telephone interviews, which last a minimum of one hour, are carried out where face-to-face meetings could not be accommodated due to time and financial constraints. The same kind of preparation has been conducted, with questionnaires being sent over in advance, research objectives being briefed and follow-up clarification pursued. Following telephone interviews have been conducted which include representatives from Houston Airport, the Department for Transport UK (DfT), British Airway (BA), British Air Transport Association (BATA), and China Southern Airlines (CZ).

Where telephone interviews are difficult to arrange due to different time zones and work schedules, email questionnaires are sent out to the following organisations which include the US Department of State (DoS) and Bureau of Air Transport of ICAO.

Although interviews are considered to be verbal reports and the responses are subject to the common problems of bias, subjective interpretation, and poor or inaccurate articulation due to different cultural and philosophical beliefs (Silverman, 2001), the interviews conducted for this research have provided great opportunities to corroborate data and important insight into the case, thus enhancing the understanding of the researcher with respect to the considerations when formulating the policy and strategy for negotiations as well as the development and progress of the consultations (Yin,

2009). The flexibility in gathering information through various types of interviews has proved to be crucial in collecting data in that it has provided an opportunity for the researcher not only to learn more about the true stories behind the scene that are only available from the participants who have had personal experience, but also enable the researcher to explore the feelings, motives, perceptions, beliefs and concerns of the participants (Silverman, 2001).

Each interview has been properly labelled with date, place, interviewee's name and main topics of discussions. While transcribing the recordings which the interviewees have agreed, ideas and wider thinking sparked off by the process have been noted down, leading to memos (Wengraf, 2001), which is a most important area for further analysis and references. Coding is tagged to the manuscripts and preliminary analysis conducted to regroup the data according to different categories. This has helped to reduce masses of data into meaningful and manageable portions, to allow the emergence of patterns of behaviour or themes that would contribute to interpretations and conclusions from the subsequent analysis (Gorman and Clayton, 1997). This coding, reflecting and "stopping for memo process" (Wengraf, 2001) has enabled the researcher to reflect the theoretical model to be applied to this research, relate to the literature reviewed, triangulate data collected from other sources and develop a systematic thinking for the subsequent analysis.

3.7.2 Documents and Records

Documents, both historical and contemporary, are a rich source of data for case study (Punch, 2005). They provide specific details to corroborate and augment evidence from other sources and allow inferences for new sources of information. Documents, both published and unpublished, tend to cover longer time spans than those collected by other methods, providing a rich vein of information for analysis on the changes of the context of the organisation. For this research, following documents and records, both published and unpublished, have been reviewed: corporate brochures; annual reports of both governments and businesses; Minutes of Meetings and Memoranda of Understanding between the governments; correspondences between various parties involved; reports of the negotiations and announcements made by both governments and businesses; internal records and circulars prepared by the governments; proceedings

and conference papers; and news clippings and mass media articles. The evidence gathered from documents review is enormously valuable as it provides a wide range of written records of the happenings, as well as the background information which is so extensive and comprehensive with unmitigated truth.

The researcher acknowledges that quite some archive files are not available for review, as they are either no longer in existence or difficult to locate as a result of office rearrangement over the years and filing requirements within a central system which denies any external access. When reviewing the documents and files, the researcher has taken notes with permission, consulted with the responsible staff for clarification and verification, and then summarised and categorised into different groupings for the benefits of subsequent inferences and analysis. Nevertheless, the shortage of some of the historical data is compensated for with the information obtained from the interviews discussed above, though not to a full extent.

The researcher is fully aware of the limitations of the data collected from documents and text files, in particular with respect to validity and reliability. This is sometimes caused by the manipulations for the purpose of public relations, which is intended to convey what the executives want to convey to the public (Rowlinson, 2006). Another issue is that the unpublished files can be casual collection of what is available for the people concerned at that time to read and review, therefore, they are not composed, collected and processed for the purposes of subsequent social legitimating. The positive side, however, of this type of documents is that they are unlikely to carry any possible biased subjective attachment to the happenings which are a more reliable and valid reflection of the truth of the event. The researcher is also aware of the volume of information available from the documents and has been prudent in not discriminatively selecting data according to personal preferences. Rather, all documents available and relevant reflecting opinions of all parties involved have been examined to ensure a rich collection of data for a subsequent fair and unbiased revision and analysis. The researcher bears in mind that such data should not be treated in isolation from their social context where the real meaning is derived.

3.7.3 Observation

Observation is widely used in case study to allow the researcher to establish what actually happens in the settings to further illuminate findings and examine situations more closely (McQueen and Knussen, 2002). Direct and unobtrusive observation enables the researcher to have access to natural settings to gather both formal and casual information, which is up to date and direct without subjective presumptions. For this research, a short period of observation has been permitted and arranged in the premises of CAAC so that the researcher is able to observe the organisation's daily activities and working environment. This has helped the researcher to develop a better understanding of their routine work and daily responsibilities. The observation has taken place randomly on any working day of the week, and notes have been taken to record what has been observed. The researcher is fully aware of the code of conduct in the observation settings and is mindful of following the set principles such as dressing and behaving appropriately, without interrupting or being destructive to their normal work. The information gathered is invaluable because it is authentic and natural with a present orientation. The behaviour and activities of the organisation are observed as a stream of actions and events as they spontaneously unfolded (Punch, 2005), which has helped the researcher to develop a better understanding of their responsibilities and how they deal with the stakeholders on a daily basis. In order to remain neutral and objective, the researcher has borne in mind, from time to time, to take note of what is happening without personal justifications. Observation data are then grouped and analysed together with the other sources of data.

3.7.4 Data and case analysis

The tactics for qualitative data analysis is well covered in the literature. There are a variety of techniques available, as Punch (2005) observed, subject to what questions are to be addressed. What is important is to ensure that the method of analysis is integrated from the beginning with other parts of the research, rather than as an afterthought, and that the methods adopted for analysis should be systematic, disciplined and able to be seen and described (Punch, 2005). The critical issue is that the analysis leads to convincing conclusions which are able to stand firm against challenges and questions.

To avoid the researcher being left in a confused situation, struggling with a mess of piled up empirical evidence, a good starting point for data analysis involves data reduction which happens through editing and segmenting all of the information collected. In order to edit and summarise the data, this researcher has gone over, time and again, the notes taken, documentary material gathered and transcripts dubbed from interviews so as to ensure that notes and marks are made where necessary. The data are then coded and memos are made based on the questions that the researcher designed to be answered for this research. Coding is one of the most important processes in data analysis because it helps to attach meaning to the pieces of data, thus enabling the summarising of data by pulling together the themes. The labelling of the data permits ready storage and easy retrieval at a later stage. After this, the data are grouped and categorised with various formats in an attempt to identify the common themes and patterns. This process has helped to reduce the data to a manageable level.

For example, the information related to political relations is grouped together while economic statistics is categorised as another group. Evidence supporting interest groups' involvement in lobbying the government is considered as a third segment. Tables are created to list all items, including names of the interest groups, dates of actions, their activities, objectives they want to achieve, results of their activities, and their strategies for the next step. Memos are produced from coding and editing when grouping and summarising the data so as to specify whether and what further actions from the researcher are needed, namely, whether verification is required from other sources and clarification is needed from the same source. This analysis of data leads to the second stage analysis which focuses on identifying all the factors that have an impact on the policymaking process, which factor(s) has (have) played a more decisive role in the process, how the factors are traded off between each other, and how these factors are evolving.

This process, despite being long and stressful, is very rewarding because it helps the researcher to streamline the threads of clues out of the bulky columns of data which helps to develop conclusions to test and build against the theoretical models identified in Chapter 2. Though the researcher has to go back and forth to the original data as well as the grouped and coded data, these steps have proved to be essential for the researcher

to establish facts and develop argument to test the theoretical model as discussed in Chapter 2.

When analysing the cases, chronological events are compiled to allow the researcher to conduct time-series analysis. By examining the sequence of events, the researcher is enabled to identify the cause and effect between the happenings to justify if a causal relationship exists, thus determining whether the decision-making is affected by the arrays of events. The three cases are then synthesised against the theoretical framework in order to fulfil the research objectives: to determine if the policies are different in each individual country-pair market, whether the influencing factors are different, and which factors are playing a more decisive role in the policymaking process.

As international air transport policy is formulated through negotiations with the other party, the whole negotiation process, namely from seeking information to formulating the agenda, negotiation strategy, negotiation process, to concluding and implementing the agreements are examined and analysed. The analysis not only focuses on international factors such as the international regime that has been governing international air transport and bilateral political and economic relations, but also on the domestic considerations of decision-makers, their preferences and choices, the impacts of interest groups and the media, and the relationships with other bureaucracies and institutions. In addition, institutional changes and the key decision-makers are included in this analysis to determine how political reform in the restructuring of institutions has affected the functions of the organisations and to what extent the institutional context and individual decision-makers are influencing the final policy outcome. To further understand the subject matter, the evolution of the acting factors at both international and domestic levels are examined, analysed, compared and highlighted so as to help to understand the changing nature of the factors and how they have affected the policymaking process.

3.8 Ethical considerations

Researchers, whatever approach has taken to collect data, recognise the need not only for being accurate in measuring things, but being logical in interpreting the meaning of those measurements (Stake, 1995). Researchers are ethically obliged to minimise

misrepresentation and misunderstanding of the data. Ethical considerations are as important as those research paradigms which include, but are not limited to, negotiations to access documents and records, confidentiality, anonymity and codes of ethics.

This researcher is fully aware that data gathering involves invasion of personal and corporate privacy and is done on somebody's "home ground" (Stake, 1995). The researcher fully appreciates that the nature of this project requires access to information, whether gathered from documented data or interviews, which can be highly sensitive and politically subtle. While many organisations are conservative in their access policy and will normally have a confidentiality policy in place, the researcher is fully committed to the code of conduct and confidentiality principles required when being allowed to review the documents after successful negotiation and explanation of the objectives of this research. In order to honour the goodwill of those organisations which have allowed the researcher to have access to such essential information as well as those who agreed for interviews, the researcher is committed to honouring the confidentiality protocol, i.e. keeping some of the names of interviewees anonymous, some of the information confidential, and limiting the public access to this research report for a certain period of time until when it is considered appropriate.

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Chapter 4 Literature Review

China began its Open-Door Policy in the late 1970s. Ever since then, the domestic political and economic landscape has altered dramatically. China has shifted from being an insular, autarkic state into one that has assumed a prominent role in global affairs, seeking to participate in the full range of debates regarding international relations among sovereign nations. Consequently, it is more inclined to the impact of international environment as well as its domestic influence. A review of the previous scholarship has revealed that there are two main strands of literature that can be referred to in respect to this research, namely the study of China's international trade policymaking and that of international air transport policymaking. This chapter therefore provides a critical review of the previous studies.

4.1 Studies on China's international trade policymaking

Studies on China's foreign trade policymaking have remained in the domain of foreign policymaking. Researchers have applied theories of international relations to the cases in international trade with an attempt to identify the factors that have had an impact on the country's foreign trade policymaking and to understand how these factors have interacted to affect the policy makers and the policy outcome.

Some scholars are convinced that China, though different from western countries, is more subject to the constraints of international regime in formulating its international policy as it increasingly integrates into the global political and economic system. They highlight the role played by international institutions and conventions in influencing the country's policymaking process and argue that its policy outcome is a reaction to the international pressure. Policymakers are only responding to the demand of international institutions to initiate the domestic policy change.

For example, Frieman (1994), taking international science and technology as one facet of international environment, argues that international science and technology does have an effect on China's foreign policy, however, this effect, to the extent they exist, are really derivatives of its effects on domestic policy. This means that the international scientific system has an impact on the country's domestic policy, which, in turn, has an

adverse impact on the country's foreign policy. She further identified some elements as the policy inputs that have affected the country's domestic policy issues, which then affected its foreign policy outcomes. However, instead of jumping to conclude that there exists a directly traceable and understandable cause-effect relationship between this input and output, she warned that such a quick assumption would be fundamentally flawed (Frieman, 1994).

Believing in the same philosophy, Yu (2007) asserted that international system draws globalisation factors into a country's domestic policymaking process, spurring domestic government institutions to establish harmonious relations with their international counterparts. This corresponding relationship, in turn, allows the international regime to go a step further in moulding the environment of domestic policymaking process to exert influence on its domestic policy directions. In his study on the relationship of international institutions and the formulation of China's policy on climate change, Yu (2007) argued that although environmental issue encompassed the domains of both economy and foreign relations, the country had not taken concrete policy actions until 1992 when it signed the 1992 United Nations Framework Convention on Climate Change. It was the recognition of this Convention as well as other international protocols that compelled the country to willingly commit to internationally-accepted practice. The international regime gave impetus to the Chinese government to establish corresponding bureaucracies and formulate coordinated policies to address the issue of climate change. The information gathered out of his interviews with scholars and officials demonstrated that around 80 percent of those involved in formulating the country's climate change policy believed that it was the international regime that was instrumental in enabling a better coordination between various government bureaucracies, leading to a harmonised policy outcome (Yu, 2007).

In contrast to those who believe in the prominent role of international regime, there are others who counter the above proposition by stressing the role of domestic circumstances supported by their empirical research. These scholars (Hao and Su, 2005; Liang, 2007; Zeng 2007; Lai, 2010,) called on the need to bring back the attention to domestic politics in influencing the policymaking process and asserted that the basic objective of a nation's foreign policy is to serve its own needs as a sovereign state,

ensuring the survival of its domestic regime and leadership. As a consequence, it is the domestic considerations that the policy makers are taking into account in determining the policy outcome.

According to Hao (2005), internal sources contributing to the policymaking in foreign affairs arena include the following: the nature of the domestic political system, state-society relations, characters, background and attitudes of its elites, bureaucratic politics, the operation of the press and other media of mass communication, the role of public opinion and special interest groups, motivational role and organisational variables within the government as well as nongovernmental variables. These domestic factors have become increasingly proactive in the country's policymaking process. They not only drive the outcome of China's bilateral trade negotiations, but are also important in shaping the country's approach towards the WTO rule-based international trade system (Zeng and Mertha, 2007).

A number of scholars have made meaningful efforts in identifying individual factors and analysing their impact on China's foreign policy making. For example, one of the most renowned investigations in the subject matter was conducted by Lieberthal and Oksenberg (1988). In an attempt to understand the role of Chinese bureaucratic institutions in the country's policymaking process, they formulated the most influential Fragmented Authoritarianism Model (FAM) and asserted that the process was protracted, disjointed and diffused as a result of the segmentation, bargaining and consensus building between those institutions whose authority over a particular policy outcome was fragmented. There was a lack of established coherent and consistent mechanism within the government regime to enable the effective coordination for a policy for the benefits of the overall economy and society as a whole. Wan (2011) explained that this kind of fragmentation should be understood from a sociological perspective as the country is experiencing a transitional period that bureaucratic institutions have to fight to hold firm their power for their survival.

Lai (2010) in his comprehensive analysis on the domestic sources on China's foreign policy making, while recognising the imperative role of elite leaders, observes that the policymaking process has become institutionalised and pluralized with multiple players emerging to be involved in the process, although their weight of influence varies. He

argues that the country's top elite leaders are no longer the sole decision makers in its strategic foreign policy issues, but rather, more organisations have been included in the consultation process, which have been set up as a result of the need to address more complicated international, regional and domestic issues such as The Finance and Economy Leading Small Group, The National Security Leading Small Group, and Ministry of State Security. Consequently, the process has become more diffused.

In endeavouring to understand how China's interest groups work to exert pressure on the policy makers, Kennedy (2005) examined the role of non-governmental organisations in steel, consumer electronics and software industries of the country. Based on more than 300 in-depth interviews with company executives, business association representatives and government officials, he argued that it was the economic circumstances of the individual industries and organisations that determined whether the industry and organisations were interested in participating in the policymaking process and how they exerted their influence. Factors such as private or state ownership, corporate size, industry concentration, and technological sophistication affected the industry's intention and willingness of involvement in this process. Companies in the same industry not necessarily shared identical voices but were inclined to becoming involved in a tug of war with the government, and with each other between themselves, in order to gain national policy advantages. They presented their arguments with their empirical business cases, provided alternative options, networked with government officials to reinforce their *guanxi* to influence the government's agenda setting with a goal of pressing for a favoured outcome for its own benefit (Kennedy, 2005).

Kong (2010) analysed China's foreign policy making by taking petroleum industry as a case study. He argued that the country's international petroleum policymaking was shaped by the decentralisation of the political reform, which moved the locus of decisions from the centre to lower-level actors, and in his case the Chinese National Oil Companies (NOCs), which were authorised to make their own production, sale and investment decisions. The policy problems were often first identified and addressed at the industry or local governmental level before being elevated to the national level. It was the local governments, big State-Owned Enterprises (SOEs), as well as the growing number of stakeholders in the policy community that gave the decision makers policy

input. Only at this time the key policy issues registered on the radar screen of the central leadership, who then perceived them as a national priority. The policymaking process, thus, became an absorptive and fluid mixture of middle-up and top-down process, which was different from those strategic and diplomatic issues.

In addition to the industry, local government is identified as another stream of interest groups which hold significant power in influencing the country's foreign trade policymaking. For example, Zhu (2005), Liang (2007) and Chen (2008) argued that local governments, especially those from coastal provinces, tended to have a bigger impact on the policy makers in central government. These local governments, motivated to stimulate local economic growth as well as to enhance their prospective political career, were capable of lobbying the central government either for a favourable policy or constraining the central government's negotiation authority through non-performance and non-implementation of certain policy for an exchange of its preferred policy outcome.

Furthermore, media, public opinions, think tanks, and the intellectuals are all recognised as important social sources that have an impact on China's foreign policy making (Yu, 2005; Zhao, 2005 and Hong, 2005). They argued that these factors, although having emerged in recent years, were beginning to influence the decision makers by channelling in the information that the elite leaders would not have access to, hence shaping their mindset and affecting their views (Zhao, 2005). Despite the fact that the mass media communication was tightly controlled to manipulate the beliefs of the public, internet forums became accessible for ordinary people to convey their voices thanks to the technology. These new factors have not only started to warp China's overall foreign policy but also influenced many aspects of the society, including its social structure and political system (Zhao, 2005).

Compared with those who concentrate on one source of factors in analysing the policymaking process, there are a few researchers who endeavour to identify factors from all sources in all levels in an attempt to capture a comprehensive picture of the variables that have an impact on China's foreign policymaking practice. A long-used device in international relations study, the levels-of-analysis approach remains a useful analytical construct for analysing complex foreign policy actions and interactions

(Shambaugh, 1994). In applying this three-levels analysis approach, namely the global systemic, societal and institutional analysis, to examine the Sino-US relations, Shambaugh (1994) argued that international circumstances had been more important variables in shaping the two countries' policy towards each other before the 1980s while factors at societal and governmental levels remained more decisive after the 1980s.

Another effort is made by Lampton (2001) who analysed the US-China relations between 1989 to 2000 by identifying factors at global, state and civil societal, and individual levels and examining how these factors interacted with each other to affect the bilateral relations in that particular decade. Drawing on his personal experience of working as Director of Washington think tank and President of the National Committee on United States-China Relations in New York City, Lampton was enabled the unique opportunity to interact with all walks of people at all levels from the mainland China, Hong Kong, Taiwan and the US to observe how they see each other and try to come to grips with the circumstances when addressing political, military, economic, and cultural issues. He observed that the Sino-US relationship had to be managed at three levels, each of which created specific challenges:

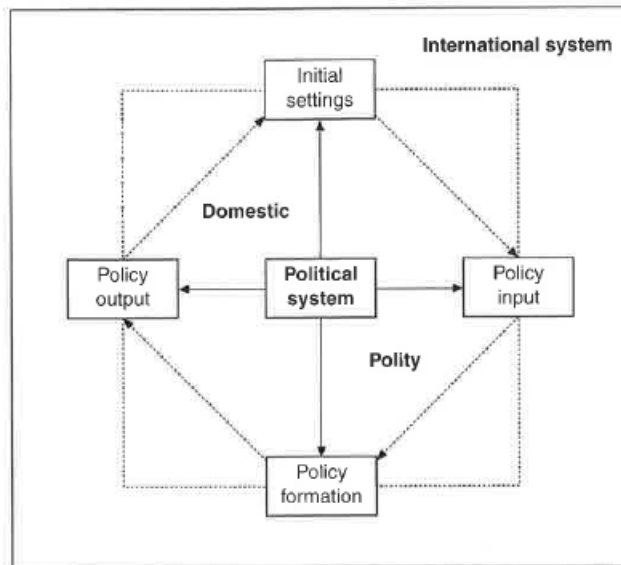
- The global level that was characterised by international organisations and regimes, the operation of international markets, and the behaviour of third parties;
- The domestic level featured by governmental and civic institutions, internal politics, ideologies and citizen opinion; and
- The level of individual political and societal leader who had had a demonstrated impact on bilateral relations (Lampton, 20001).

He argued that societal groups and government entities wielded considerable power to apply pressure to influence policy. More forces transcended beyond the nation state's borders resulting pressures undertaken by other countries that were difficult to ignore. National leaders faced the great dilemma of how to reconcile the demands of powerful domestic groups to maintain arrangement from which they have benefited with the demands of external constituencies such as foreign governments, multilateral organisations, or multilateral firms. This combination of domestic and international

demands, each with internal and external consequences, was blurring the distinction between foreign and domestic policy (Lampton, 2001). He believed that both Chinese and American leaders, especially aspiring politicians, were actually tempered to use domestic anxieties stemming from external demands to their own benefit by advocating assertive, unilateralist policies.

The very latest comprehensive study has been conducted by Feng (2006) on China's decision to enter the WTO. Based on Sheng's (2002) general model of policy process, Feng developed his own analytical framework and applied to his WTO case study (Figure 4.1). He identified various actors and examined their role as well as the evolution of and the interaction among actor's ideas, preferences, institutional structures and power configurations in the policymaking process. He explained that this model featured a two-level game between domestic and international actors and structures depicting the two dimensions that would interact on both logical and empirical stages of the policy process. Based on his model, he identified elite politics, bureaucratic politics and international/transnational politics as key variables in influencing the policymaking process, with ideas, preferences and institutional structure being sub-variables that have shaped those actors' policy behaviour (Feng, 2006). He concluded that the paramount Chinese Communist Party (CCP) elites were the critical driving force on the country's strategic policies and the government's agenda, although their decisions have been dragged in a bureaucratic muddle in the policy process by a compartmentalised institutional system. It was their determination that bypassed and prevailed over a reluctant and resistant bureaucracy to keep the momentum and move the country towards the integration into the global economic system. Compared with the elites' decisive role in enabling the policy change, actors such as multinational bodies, foreign governments, especially the US, and foreign businesses were also able to exert influence on China's trade policy by either exporting international accepted rules into China, or by exerting direct pressure and collective action in bilateral negotiations.

Figure 4.1 Feng's analytical framework on China's WTO policymaking.



Source: Feng (2006)

In summary, scholars, supported by their empirical findings, have made significant contribution to the study of China's foreign trade policymaking. Their research has greatly helped enhance the understanding of the mysterious process of China's foreign trade policy making. To argue one level of analysis is superior than the other should not be the focus of the academic debate, but rather how the research results contribute to knowledge.

4.2 Studies on China's international air transport policymaking

Until today, there has been little systematic and in-depth study on China's international air transport policymaking, though there exists a limited volume of research on China's air transport industry, which are scattered in various publications by various researchers. The first effort, according to the knowledge of this researcher, was made by Le in 1997, who, in analysing China's economic reform in airlines industry, observed that the structural change of China's airline industry was a result of the central government's political initiative. Zhang (1998) furthered this argument asserting that CAAC was reacting to the central government's call to transform thousands of large- and medium-sized SOEs to profit-seeking economic units in the market economy. Like many SOEs of other industries, airlines' financial performance was unsatisfactory and severe losses

were recorded in the 1960s and 1970s despite government subsidy. In addition, the industry was stagnant in terms of traffic demand because airlines were not operated for commercial purposes but to serve the administrative needs of government officials.

This view of domestic conditions taking priorities in the decision making of the government to intensify the industry reform was reinforced by studies conducted by Zhang and Chen (2003), who argued that the domestic situation was the primary consideration when formulating the liberalised policies. These considerations included low traffic demand from domestic passengers who were discouraged by the restrictive international travel policy and a lack of human capital and management expertise of the industry. State-owned large carriers, as a result of years of growth and industry consolidation, emerged to become monopolistic and oligopolistic firms at the expense of real market competition and were able to leverage their market power in influencing the government policymaking process. Consequently, requests for market entry and increase of capacity from foreign governments tended to be rejected given the domestic circumstances.

However, these researchers (Le, 1997; Zhang, 1998, 2003; Zhang and Round, 2008; Shaw et al, 2009), when discussing about the domestic politics, failed to analyse the country's international air transport policy. Rather, they treated the policy change as background information that triggered the industry's structural reform, instead of analysing how the policy change was initiated and what drove such policy change.

Contrasting to the above, other scholars, when attempting to understand the forces driving for the liberalisation of international air transport in Asian countries, have universally identified the pressure from the US as the sole factor in enabling this change. For example, Kasper (1988) pointed out that it was the successful replication of the "stick and carrot" tactic that forced the Asian countries to accept what the US had offered to enable the US to achieve what it wanted in Asia, as it did in Europe. For example, the US chose a small but strategic country to start with the Open Skies discussions. The first target was Singapore, a tiny city state without any domestic market but relying heavily on transnational business and always favourable to free trade, with whom such an agreement was concluded in January 1997. This was shortly followed by similar agreements with Brunei, New Zealand, Malaysia and South Korea,

thus allowing the US aviation businesses to exploit first-mover advantages. At the same time, such arrangements caused significant concern from other countries in the region as some of the provisions in the Open Skies including the hubbing rights in a foreign territory and change of gauge could severely affect the operations and competitiveness of all Asian carriers. The strategy proved so successful that these small countries were used by the US to leverage the larger ones such as China and Japan. Eventually, the strong US pressure has led to liberalisation on US-Japan market as well US- other Pacific-rim country market.

Oum and Yu (2000) explained that the US government was able to take advantage of its well established and commercialised airline industry to gain favourable traffic rights from Asian countries ever since the WWII. Asian countries did not pay much attention to international air transport as they did not see the commercial significance and prospective value of the industry, hence granting what the US wanted. It was not until mid-1980s that the Japanese government became the first Asian country to voice its dissent regarding the asymmetric rights, threatening to repeal the 1952 bilateral ASA for a renegotiated deal, since Japan Airlines began to lose market share to the US carriers, especially to Northwest, United Airlines and Fedex. Other Asian countries and regions such as South Korea, Philippines, and China Taiwan, though not happy about the situation, were reluctant to get along with the US despite they were allowed access to more US cities. Exploiting the benefits of bilateral negotiations with each of the Asian countries, the US was able to tactically conclude the agreements favouring the US carriers, with provisions such as the fifth traffic rights to allow US carriers to use cities such as Tokyo and Seoul to capture the traffic between Asia and Americas.

Oum and Lee (2002) further noted that foreign carriers such as those in the US and Europe were able to exert great pressure on their Asian counterparts, which adversely had an impact on the country's international air transport policy. After years of liberalisation, the carriers in the US and Europe were very ambitious to expand into the Asian market, where air transport has been growing at a phenomenal rate. The 5th freedom traffic right would allow them to improve their networks and to gain a greater market share. Despite their demand was resisted by Asian countries, e.g. US bilateral relations with Japan, Hong Kong and the Philippines used to be stalled over the issue,

the impact was long-term in that Asian countries, including China, started to make liberalisation one of the top items on their agenda

In addition to the pressure from the US, Zhang and Chen (2003) have identified the geopolitical changes in the region as another factor that has affected China's approach towards liberalising its international air transport market. They noted that the change of sovereignty of Hong Kong in 1997 had had a significant impact on the Mainland China-Hong Kong bilateral and the linkage, through Hong Kong, between China and the rest of the world. More relaxed bilateral arrangements in terms of market entry and capacity were agreed between China and its foreign counterparts to reflect market demand.

Bonin (2009) argued that China's involvement in regional economic integration mechanisms such as ASEAN and APEC also had an impact on China's view on air transport, which has been designated as one of the twelve "priority sectors" for such integration, with an ASEAN "Open Skies" scheme tentatively scheduled by 2015. Although China is not a member state of ASEAN, the ASEAN plus China model allows China to actively participate in ASEAN activities, including discussing the possibility of an ASEAN-China Air Services Agreement, pursuant to the ASEAN-China Aviation Cooperation Framework promoted under the auspices of supporting a more overarching ASEAN-China Free Trade Agreement (Bonin, 2009).

Joining the WTO was another push for China to adopt a more liberal attitude towards international trade, including international air transport. Reviewing the implications of China's access to the WTO on its logistics industry including air transport, Li and Zhang (2003) claimed that the aviation industry would benefit as a result of the expanded foreign trade and FDI following the WTO, with the air cargo industry benefiting from the relocation of those foreign productions that were subject to just-in-time pressures, such as electronics, computer, pharmaceuticals, IT and other high-tech industries. They argued that although there were only limited areas in air transport that were covered in China's commitment to the WTO, the entry would likely bring about a series of policy changes in the following years. It would be a good time for China to consider a SAR Hong Kong-Mainland Open Skies Bloc to allow the country to gain valuable bilateral and multilateral experience and possibly consider an Open Skies Bloc for Northeast Asia with Japan and South Korea, where economic growth has continued

over the last two decades and the intra-country trade and economic link has been strengthened and expanded. They believed that the WTO would provide a good opportunity for the Chinese carriers to expose to competition with more efficient rivals and offer advantages for the integrated express air cargo sector.

Luo and Findley (2004), however, was conservative in anticipating a dramatic change in the air transport sector in the early years after China's accession to the WTO although there was a positive effect on performance in the logistics sector as a whole. They held the view that air transport was to remain quarantined from GATS coverage except for a limited number of complementary services because China's commitment was relatively limited in a few areas. For example, WTO only covers the aircraft repair and maintenance service. China's commitment to this area was to permit foreign service suppliers to establish joint ventures in China, with Chinese side holding a controlling share or being in a dominant position in the entity. With respect to Computer Reservation System (CRS) Services, China's commitment was to allow the foreign CRS to provide services to Chinese aviation enterprises and agents by connecting with the Chinese CRS. They were also only allowed to provide services to representative offices and sales offices established in the destination cities in China by foreign aviation enterprises that have the right to engage in business under the bilateral aviation agreements. Any direct access to and use of foreign CRS by Chinese aviation enterprises and agents of foreign aviation enterprises must seek for approval from the central government. Such a commitment to a great extent would protect Chinese aviation enterprises in the foreseeable period of time, which would buy time for the government and the industry to develop and grow its competitiveness. In light of such commitment, there was no urgent need for the government to make policy changes to meet the immediate challenge.

Contrary to the above scholars, Dougan (2002) was the first to treat policymaking in China's air transport industry as a subject matter to study. He applied the FAM to the industry, i.e. domestic air transport operation and manufacturing, with an attempt to examine how the various factors had influenced the policymaking process. He asserted that the FAM seemed to be able to provide a useful framework for understanding the state-centric variables driving policy changes in civil aviation sector as it showed that

both the top central levels of the system and the lower bureaucratic areas were key factors in shaping the development of the industry. However the Model on its own could not tell the full story of what has driven the civil aviation industry in the contemporary reform period. New non-state variables have emerged on the Chinese scene, which were not present to the same extent as in the mid-1980s when the Model was constructed. By grouping those non-state variables into four categories, namely marketisation, destatisation, decentralisation and globalisation, he asserted that these factors were capable of affecting the state's policymaking process while at the same time remaining independent in their own right existing outside the policy arena and able to influence the economic activities of the industry.

He concluded that there was no evidence that the central leaders from institutions such as Politburo, the State Council (SC) or the Central Military Commission (CMC) had taken an active part in the industry's affairs. The state, more specifically the central government, was not noticeably very important in terms of influencing the industry's decision-making. This was because, first of all, unlike some big national-level projects involving several industries and economic sectors like the Three Gorges Dam, civil aviation has been an established industry with an administrative chain of command being in place for decades which did not require the personal involvement of the senior central leaders in the day-to-day activities. Aviation as an industry rather than a project was not limited in time and space, which did not exhibit in the same type of central-level personality-driven authoritarianism evident in fields such as energy that the FAM was based on. Secondly, because civil aviation was so intimately related to defence and national security, the role of central leaders with the policy process was not made public and much secrecy and ambiguity surrounded the industry's core decision-making. In this sense, the role of central leaders appeared outward low, but this might only be because so little was known about the heart of the industry where it would be expected they should play a major part. Hence, the role of central leaders in civil aviation, while undoubtedly not negligible, remained highly problematic due to information limitations (Dogan, 2002).

He also concluded that the decision making was in the hands of those bureaucratic bodies at ministerial level charged with the responsibility of governing the industry,

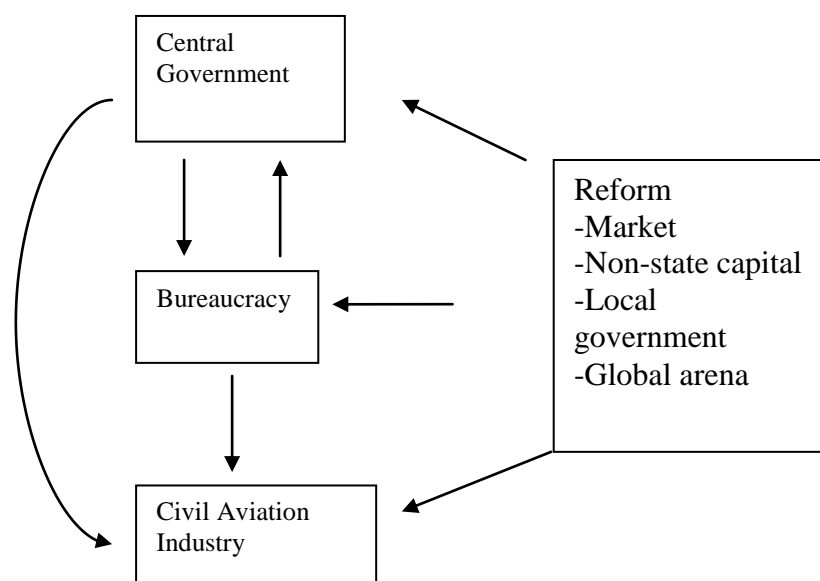
namely CAAC for air services and Aviation Industries of China (AVIC) for aviation manufacturing. There was a significant amount of interaction between the two systems, but they remained quite independent of each other, reflecting the natural divisions inherent in the broader civil aviation industry. Horizontal systems played no formal or institutionalised role in either side of the industry, making each part of civil aviation less bureaucratically fragmented than other economic sectors such as energy, in which local levels were institutionally involved. Both CAAC and AVIC were able to wield enormous authority over their respective sides of the industry and could call upon a range of institutional powers unmatched by identical aviation organisations existing in countries such as the US or Australia. Both had the power to make sweeping changes and were the preeminent and most outwardly visible decision making centres of the industry (Dogan, 2002). However, he recognised the requirement of these institutions to work and share with other domestic organisations of equal or sometimes greater authority or rank when addressing industry issues. For example, the military still played a key role in decision making in terms of operational functions. The Ministry of Foreign Trade and Economic Cooperation ² (MOFTEC) and State Development and Planning Commission (SDPC) were involved in determining the industry's foreign trade and administrative planning process, although CAAC exercised a high degree of authoritative control over the industry. Such a practice produced a parallel fragmentation of authority along organisational/bureaucratic lines. He asserted that it was this twin authoritative and fragmented organisational structure and the processes that constituted the core feature of China's civil aviation industry. As there were still a lot going on in the industry that lay beyond this organisational/bureaucratic structure, neither CAAC, AVIC nor the host of other military and civilian state organisations was able to exert any impact.

In assessing to what extent the new variables have influenced the decision making process and how important these non-state factors were in the determination of the policy outcome, Dogan (2002) observed that marketisation has not had the same impact on civil aviation as in some other Chinese industries which were less strategic and allowed to operate more freely from state controls, despite that the effect of markets

² currently Ministry of Commerce (MoC)

and market forces had been noteworthy in certain cases, like the airfares competition in mid-1990s. CAAC and the national government had little control over these developments but had to respond by imposing strict new air fare regulations that were not followed by all carriers. The destatisation, namely allowing private capital to the industry and floating of aviation enterprises in the stock market could exert a potentially powerful influence on the industry and a significant impact on policy choice, though more on the manufacturing side. Finally, there was the global arena and the greater external actors and forces that had an impact on the industry. This was best reflected in the manufacturing aspect of the industry which was so intimately tied to the military, it therefore was particularly vulnerable to foreign pressure and subject to the government's broader political relations with the US and Western Europe. Air services, too, were vulnerable to external vagaries, as evidenced by the fact that during the height of the Asian financial crisis airlines had to switch from troubled Japanese aircraft leasing firms to others in North America and Western Europe, which offered less attractive financial terms. This kind of external event altered the cost structures of airlines and dovetailed in an unwelcome fashion with the falling revenues brought on by domestic airfare discounting. Based on his findings, he went on suggesting an amended model to FAM and called it the Reform Model (Figure 4.2), in which, he incorporated those elements that he has identified.

Figure 4.2 Dougan's Reform Model (2002).



Source: Dougan (2002).

Dougan's study has made a significant contribution to the understanding of the policy making process covering a broad spectrum of the sectors across the industry, from manufacturing to air transport service provision. However, his study did not cover the element of international air transport, which always involves another country to establish how China's country-specific international air transport policy is made and what are the factors that have an impact on its policymaking process, its position and considerations when negotiating with its foreign counterpart. The lack of this investigation is regrettably a big flaw to his tremendous efforts.

The latest attempt was made by Williams (2009), who, based on his teaching experience in China, traced the political forces that have underpinned the reform process of the industry since the country embarked its search for socialism with Chinese characteristics in 1978. He argued that the Chinese approach to economic and social reform was a reflection of a high degree of ideological continuity in the Chinese Communist Party (CCP) since it claimed power in 1949. From Four Cardinal Principles (FCP)³, to Three Represents (TR)⁴ and the Concept of Scientific Development (CSD)⁵,

3 The FCP were set forth by Deng Xiaoping in 1979 which were to guide the processes of China's political reform. These principles included the following: Keeping to the Socialist road; Upholding the dictatorship of the Proletariat; Upholding the leadership of the Communist Party; and Upholding Marxism-Leninism and Mao Zedong's Thought (Williams, 2009).

4 TR was proposed by Jiang Zemin in 2000 with an aim of strengthening the controlling status of the CCP. They refer to the following: (the CCP) representing the development trend of China's advanced productive forces; representing the orientation of China's advanced culture; and representing the fundamental interests of the overwhelming majority of the Chinese people (www.english.cpc.people.com.cn/66739/4521344.html).

5 CSD was put forward by Hu Jintao in 2003. It refers to the approach taken by the central government in managing the relationship between economic development and social development. It means that the country will pursue a scientific outlook on development that makes economic and social development people-oriented, comprehensive, balanced and sustainable. It will work to strike a proper balance between urban and rural development, development among regions, economic and social development, development of man and nature, and domestic development and opening wider to the outside world (http://english.peopledaily.com.cn/200604/22/eng20060422_260256.html).

the sequential introduction of these ideological doctrines has allowed the CCP to claim formal historical legitimacy as the constitutional leader of the country, hence controlling its political and economic system. The ideological inputs underlying the country's reform strategies have remained a dominant theme, governing the direction of its overall development over the last few decades.

As a consequence, China's policy change has been, to a great extent, the result of the CCP's initiative in an attempt to optimise its national interests in its pursuit of a continuous and stable power. CAAC, the government agency charged with the responsibility of formulating international air transport policies, though having gone through several administrative reforms since 1978 with its tasks and responsibilities being adjusted, has played a critical role in spearheading China's international air transport policy and leading the industry through the regulatory reform. Remaining to be the sole administration representing the Chinese government in negotiating ASAs with foreign countries, CAAC was able to effectively oversee the industry's reform, while at the same time strengthening its institutional status within the national bureaucracy along with the process of the commercialisation of the industry, thus bringing itself closer to the centre of power within bodies such as the SC. The underlying political aspect of China's civil aviation industry has played a bigger role than that in any other country of the world, making China's aviation reform more complicated.

In commenting on the impact of the US as well as the EU in China's efforts to remove the barriers for a liberalised air transport arrangement, he observed that the US was able to leverage its political relationship with China to move forward the bilateral air transport negotiations whenever there was a deadlock, and the various kinds of dialogues and forums at executive level such as Strategic and Economic Dialogue (SED) provided such a good opportunity for both parties to continue the communication, resulting in the US being able to have access to the Chinese market in respect of the air transport provision as well as construction of all modes of transportation system (Williams, 2009). Likewise, the EU is able to integrate air transport into a normative part of the overall trade development between the two parties since 1990, with the aim of exploring opportunities for future aviation agreements

(Williams, 2009). He pointed out that the EU managed to bring the liberalisation of the air transport market into a broader range of issues of mutual interest including safety, security, environmental matters and the application of competition law, thus achieving a joint commitment to facilitating the operations of airlines for the benefit of the public at large. Such a tactic would loom very large in the course of any further negotiations.

Williams' efforts serve as a turning point in the academic studies focusing on China's air transport industry by bringing in the political element into the analytical framework. His findings have significantly shed light on the understanding of the rationale behind China's policy changes in aviation industry. Nevertheless, he did not apply any theoretical models to his analysis, thus lack of theoretical vigorousness.

4.3 Summary

Research and analysis on policymaking with respect to international trade and international air transport has been flourishing, giving us a great insight to the changing nature of the industry and helping us to understand the rationale of such changes. However, as time changes, all understandings and knowledge need to be embraced with the new environment to reflect the changes. As China is more and more integrated into the world economy, international air transport will have a bigger role to play to contribute to Chinese "going global" strategy, and the policy therefore will, to a great extent, affect not only the air transport industry but also logistics and international trade at large. Revision of the literature helps us to develop a clear and comprehensive picture of the previous research findings, which also reveals what else needs to be done. Based on this understanding, the following chapters are the empirical research that is intended to identify the factors that influence China's international air transport policymaking process and examine how these factors have interacted with each other to influence the policy making process and how these factors have evolved over the decades.

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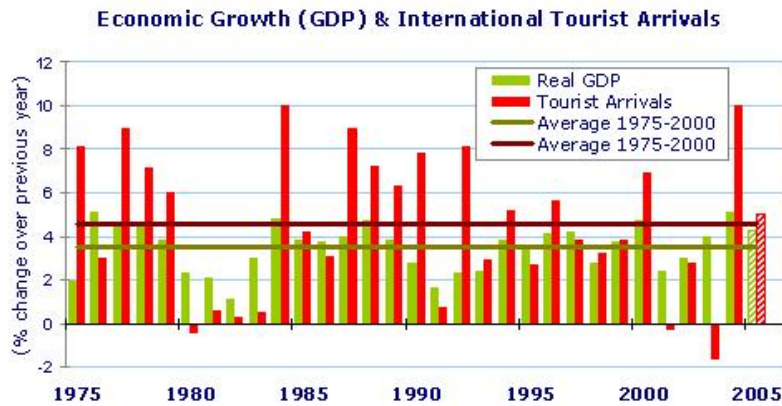
Chapter 5 Characteristics of China's international air transport industry

5.1 China's economic growth and its air transport industry

Air travel and economic growth are closely related to each other. On the one hand, the demand for air travel depends heavily on economic conditions, while on the other hand, the availability of air transport services has effectively increased the scope and cycle time of economic activities, which, in turn, drives the demand for passenger travel and freight movement (Ishutkina and Hansman, 2007). This co-relationship is best reflected by leisure travel, which relies on the proportion of disposable income (www.unwto.org). Likewise, freight transportation has always been an integral component of economic development, supporting every element of supply chains and contributing to the trade and service activities that cover all stages of production (Leinbach and Capineri, 2007). The fast growth of freight transport is partly because the regulation with respect to cargo operation is more liberal than that for passenger operation. The changed pattern of production with outsourcing in developing countries such as India and China has become an industry norm, thus leading to a significant growth in freight flows worldwide (Leinbach and Capineri, 2007).

Air transport has always been a high-growth industry with the world passenger traffic enjoying an average of annual growth rate of 12 percent between 1945 and 2000 (Hanlon, 2007). Generally speaking, the growth of international passenger arrivals tends to significantly outpace the growth of economic output as measured in Gross Domestic Product (GDP). The traditional "rule of thumb" measure for transport market is that the GDP multiplier is around 2, indicating that air travel demand will grow or decline twice as fast as any changes in GDP (O'Connell, 2007). The model produced by Chin and Tay (2001) when examining IATA's data on passenger traffic since the 1970s revealed that the GDP multiplier has been in the range of 1.5-2.2. As Figure 5.1 demonstrates, the sharp increase of tourist arrivals were observed in the years between 1985 and 1991, 1993 and 2005 when the world economy grew strongly. While the years between 1980 and 1984, 1998, 2001 and 2003 saw a decrease in passenger arrivals as a result of the economic downturn due to the fuel crisis, Asian financial crisis and terrorist attacks.

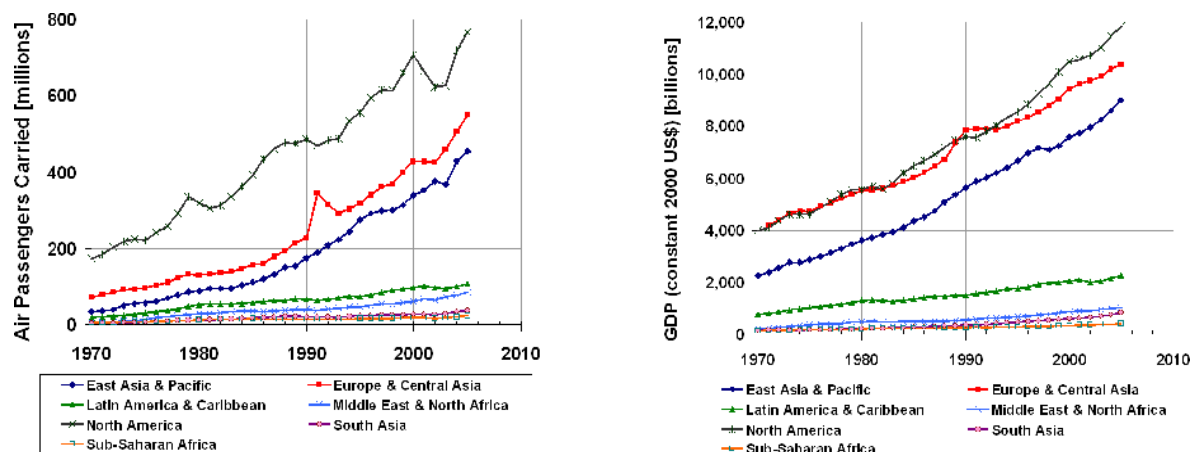
Figure 5.1 Economic growth and international tourist arrivals between 1975 and 2005.



Source: www.unwto.org

However, a substantial variability has been observed in different regions in terms of air traffic growth against GDP (Ishutkina and Hansman, 2007). Traffic in Asia Pacific and the Middle East tends to grow faster than that in other regions including Europe and the American, while sub-Saharan Africa traffic remains at a slower rate of increase (Figure 5.2).

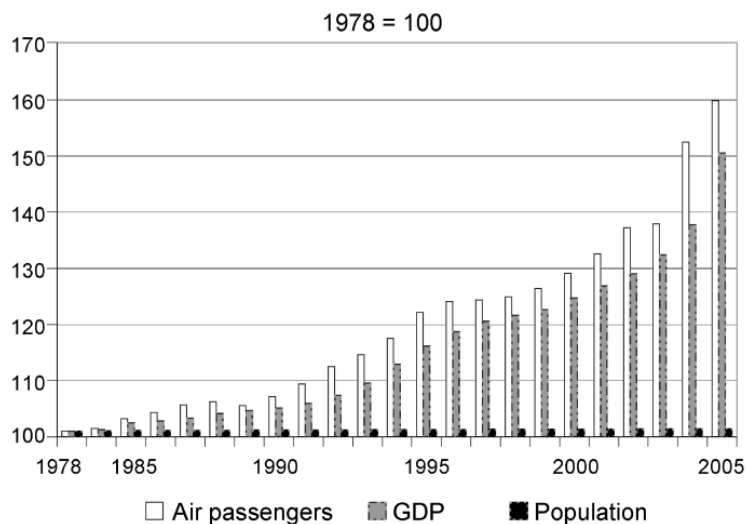
Figure 5.2 The correlation between GDP and air travel in different regions of the world between 1970 and 2010.



Source: Ishutkina and Hansman, 2007

In terms of China, the country's GDP had grown from \$216.5 billion in 1978 to \$3.6 trillion in 2007 with an average growth rate of 9.8 percent per annum (www.stat.gov.cn), much higher than the world average of 3.0 percent for the same period of time. It is also higher than Japan whose growth rate was recorded at 9.2 percent during its economic take-off period and South Korea which reported 8.5 percent economic growth for the same period. Data from the International Monetary Fund (IMF) showed that China's GDP was ranked 4th in 2007⁶, compared with its ranking of 10th in 1978, contributing to 6 percent of the world total. Accordingly, the country's average growth rate in air passenger traffic between 1985 and 2005 was recorded at 15.8 percent (Figure 5.3) (Wang and Jin, 2007).

Figure 5.3 China's air traffic growth compared with its GDP and population growth, from 1978 to 2005.



Source: Wang and Jin, (2007)

5.2 Air transport development compared with other transport modes

China's remarkable economic growth has been accompanied by the extensive development of the country's transportation system (Zhou and Szyliowicz, 2006), which the central government has invested heavily with an aim of promoting export-oriented economy and improving the quality of life. Such a growth is reflected by the

⁶ In 2009, China overtook Japan to become the world's second largest economy.

increase of passenger volumes carried by all modes of transport except waterways, which has experienced a steady decline. Although road transport still accounts for more passengers, air transport has seen a massive increase of traffic. In 1978, Chinese airlines carried only 2.3 million passengers, compared with 814.9 million passengers by rail and 1,492 million passengers by road. In 2007, airline passengers increased to 186 million, compared with 1,357 million by rail and 20,507 million by road (China Communication Yearbook, 2008). Table 5.1 shows the changes in passenger traffic between 1978 and 2007.

Table 5.1 Passengers carried by different transportation modes between 1978 and 2007 (in million).

Transport mode (in million)	1978	1980	1990	2000	2007
Highway	1,492.3	2,228.0	6,480.9	13,473.9	20,506.8
Rail	814.9	922.0	957.1	1,050.7	1,356.7
Water	230.4	264.4	272.3	193.9	228.4
Air transport	2.3	3.4	16.6	85.9	185.8

Source: Adapted from China Communication Yearbook 2008

Corresponding with the passenger traffic, freight transport has experienced unprecedented growth too. According to China National Statistics Bureau (CNSB), all transportation modes carried 22.8 billion tonnes of cargo, realising 10.1 trillion Revenue Tonne Kilometres (RTK) in 2007. This represented a 7.9 percent increase year on year growth compared with 2.5 billion tonnes of cargo in 1978 with 983 billion RTK. Of all transportation modes, air cargo transport experienced double digit growth rate, much higher than the rest (Table 5.2) (www.stats.gov.cn).

Table 5.2 Freight volumes, RTK, and growth rate between 1978 and 2007.

	Volume carried (in million tonnes)		Change (%)	RTK (in billion tonnes kilometre)		Change (%)
Year	1978	2007		1978	2007	
All	24,900	22,800	7.9	983	10141.9	8.4,

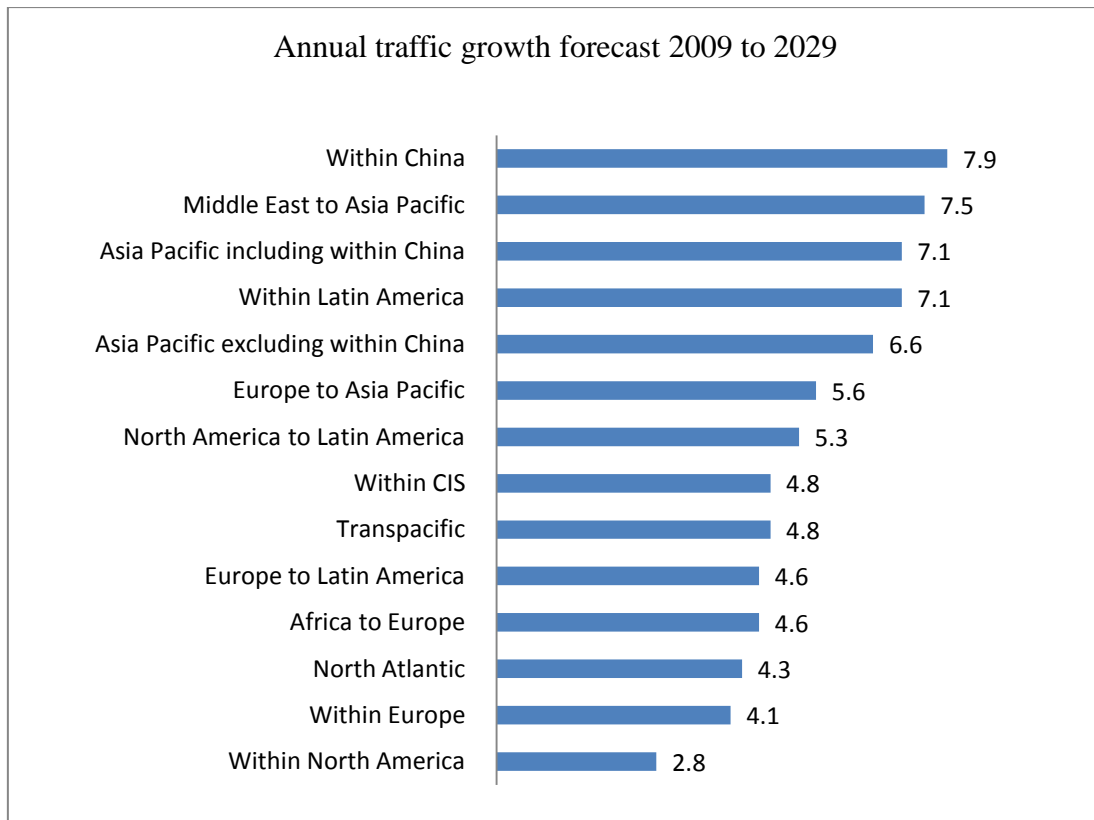
modes						
Rail	1,100	3,140	3.7	534.5	2379.7	5.3
Highway	850	16,400	10.7	27.4	1135.5	13.7
Water	430	2,810	6.7	378	6428.5	10.3
Air	0.064	4	15.3	0.1	11.6	17.9
Pipeline	100	410	4.8	43	186.6	5.2

Source: www.stats.gov.cn

Accordingly, the market shares of the different transport modes have changed. In 1978, rail transport played the biggest role in moving traffic, taking more than 60 percent market share, with air transport accounting for only 1.6 percent, a tiny slice of the market. In 2007, rail transport had lost almost half of its market share plummeting to only 33.42 percent, with air transport gaining a 12.93 percent with an average annual growth rate of 15.8 percent compared with 9 percent of other transport modes.

Looking into the future, Boeing (2010) estimates that China will become the largest domestic and international travel market over the next 20 years with passenger traffic demand growing at a rate of 7.9 percent compared with a world average of 4.9 percent (Figure 5.4). In terms of air cargo traffic, Boeing estimated that it would grow at 9.2 percent for the period of 2009 to 2029 compared with a world average of 5.4 percent, with the country's economy continuing to grow at an average rate of 7 to 8 percent per annum (Boeing, 2010). Business Monitor International (BMI) (2010) is more optimistic by projecting that China's air freight will grow at 9.7 percent for the period of 2010 to 2014. To meet the demand for air transport, China will take delivery of 3,770 new airplanes by 2028, accounting for 42 percent of the entire Asia Pacific market and valued at \$400 billion dollars (www.boeing.com).

Figure 5.4 Boeing's forecast for air passenger travel growth from 2009 to 2029.



Source: www.boeing.com

5.3 China's air transport policy

Unlike European countries and the US which have a clear vision with respect to air transport policy, Asian countries have divergent policies and objectives. Some advocate a free and liberalised market while others are not sure as to what they want to achieve, in particular the less developed countries (Forsyth et al., 2006). In the case of China, the objective of its air transport policy has been changing over the last three decades, with enthusiasm for liberalising the market being both high and low, as a response to both internal and external circumstances. The industry, thus, has gone through several uncertain periods of deregulation, which has boosted growth but is then followed by tight regulatory actions taken by the central government in an attempt to control the overheated development (Williams, 2009).

Until 2003 there had been no explicit policy with respect to air transport spelled out in any Government white papers, including the Strategic Five-Year Plan and Annual Plan. Liberalisation had not been an acceptable word to use, the whole concept being a very sensitive issue and one not widely accepted across China. As a consequence, domestically, the government was responding to the rapid growth in a passive way, with laws, rules, regulations and procedures being issued for rectification of industry misconduct. Internationally, each bilateral agreement was dealt with on a case-by-case basis, thereby giving rise to flexibility but also uncertainty (Forsyth et al., 2006). The lack of vision resulted in ambiguity in policy objectives, thus, sending mixed and confusing messages to the industry, which in turn had to react passively to any challenges from both within and outside China.

5.3.1 Relaxing economic controls on domestic market

Relaxing economic controls on domestic air transport market went hand in hand with the country's overall economic reform. By introducing a series of measures to lift the restrictions on investment, route licensing, pricing and airport charges, the preliminary aim of the government was to ensure that air transport was able to provide convenient and efficient links across the nation, thus facilitating the economic growth. The first measure was taken in 1984 when CAAC allowed more airlines such as Xiamen Airlines and Shanghai Airlines to be established in 1985 and 1986 respectively, with the funding coming from both local government and other state-owned enterprises in the region. This was followed by the establishment of seven trunk airlines on the basis of the operations of CAAC's regional administration in seven cities, i.e. Air China (CA) in Beijing, China Eastern (MU) in Shanghai, China Southern (CZ) in Guangzhou, China Northern in Shenyang, China Northwest in Xi'an, China Southwest in Chengdu and Xinjiang Airlines Urumqi. By 1995, there were 42 airlines operating in the country, some only having a fleet of less than five aircraft.

The provision of air transport services significantly contributed to the local economic growth but at the same time caused severe safety concerns, with nine aircraft crashes recorded between 1992 and 1993. The inadequate safety management system, a serious shortage of experienced pilots, a lack of management experience and ineffective

government regulation was to be blamed for the tragedies, which resulted in CAAC's tight control in approving any new airlines. Measures were also taken to encourage consolidation with smaller airlines being taken over by trunk carriers, leaving the total number of air operators being less than 30.

The tight control on market entry remained unchanged until 2004, when CAAC responded to the call of the national government that private investment was welcomed in the air transport industry including airlines, airports construction and ground handling services. It was also a response to the central government's commitment to the WTO, which accepted China's membership in November 2001. Tens of regulations, orders, programmes and proposals were issued between 2004 and 2008 to relax the economic restrictions in terms of market entry and price control in the domestic market (Table 5.3).

Table 5.3 List of key regulations regarding domestic operations issued by CAAC between 2004 and 2008.

Date of entry into force	Regulation title	Key points	Reference number
6 th February 2004	Proposed Programme to Speed up the Development of Air Cargo	<ul style="list-style-type: none"> • Allowed establishment of all cargo airlines • Allowed the development of cargo hubs • Relaxed cargo route licensing • Allowed flexible cargo rates within an approved range 	CAAC YUN (2004) 28
20 th April 2004	Pricing reform programme with respect to domestic air transport	<ul style="list-style-type: none"> • Allowed market-determined pricing for regional and feeder routes, and flexible pricing within an agreed range on trunk routes 	CAAC 2004-18
1 st January	Regulation on	<ul style="list-style-type: none"> • Allowed establishment of 	CAAC Order

2005	Air Operator's Certificate	commercial civil aviation enterprises	No. 138 (CCAR-201)
15 th August 2005	Regulation on Domestic Investment in the Civil Aviation Industry (Provisional)	<ul style="list-style-type: none"> • Allowed private investment in the air transport industry, including the setting up of commercial airlines, and the construction of airports and investment in air traffic control systems. 	CAAC Order No. 148 (CCAR-209)
20 th August 2005	Regulation on Merger and Restructuring of Aviation-related Business	<ul style="list-style-type: none"> • Allowed restructuring and mergers of aviation-related businesses • Allowed IPO and equity restructuring • Allowed contract management 	CAAC Order No.149 (CCAR-229)
20 th March 2006	Regulation on Domestic Route Licensing	<ul style="list-style-type: none"> • Allowed airlines to operate on most of the domestic, regional and feeder routes by filing at the CAAC and their regional branches, unless otherwise specified 	CAAC Order No.160, (CCAR-289TR-R1)
28 th December 2007	Airport Charges Reform Programme	<ul style="list-style-type: none"> • Airport charges based on categories of airport operations. • Aeronautical charges decided by Government • Non-aeronautical charges determined by the market 	CAAC 2007.158

		within an agreed range	
12 th March 2008	Procedures in Managing Domestic Route Licensing of Air Transport	<ul style="list-style-type: none"> • 45 days prior to the actual operation to lodge the application for the route licence • 30 days for processing after receiving the application • The licence will be revoked should no flights be operated within 60 days of the issuance of the licence, or the actual operation was less than 50% of the original application. 	N/A

Source: compiled by author from the information on www.caac.gov.cn

These measures prompted a second wave of rapid growth in the number of airlines similar to that of the late 1980s and early 1990s. New carriers, such as Spring Airlines, Juneyao Airlines, and Okay Airlines with private capital, were approved in 2005 to operate in the domestic market. Joint-ventured cargo operators such as Great Wall International (joint venture between China's Great Wall Industrial Co Ltd and Singapore Airlines) and Jade Cargo International (joint venture between Shenzhen Airlines and Lufthansa Cargo) were permitted in 2004 to serve all cargo international routes. Before 2004, there were 27 carriers operating in China, while by the end of 2007 there were 41 in operation. The increase of airlines brought about a dramatic increase of capacity and services. In 2003, there were a total 961 domestic routes connecting 148 airports and 194 international routes connecting 72 cities in 32 countries. By the end of 2008, the 41 carriers operated on 1,235 domestic routes connecting 156 domestic cities and 297 international routes connecting 104 international cities in 43 countries (www.caac.gov.cn). Passenger traffic grew from 87.59 million in 2003 to 185.76 million in 2007 and RPK rose from 126.3 billion in 2003 to 279.2 billion in 2007 (www.caac.gov.cn).

5.3.2 Liberalising international air transport

Liberalising international air transport market has been a long, gradual and on-going process for China. Failing to recognise the pivotal role that international air links could play in facilitating the country's export-oriented economic growth, CAAC's primary concern in the early days of the reform was to ensure that the newly-formed carriers were able to optimise the advantages gained from their respective geographical locations so that they were not competing with each other in terms of route operations. To this effect, CAAC stipulated clearly the business scope in each of the carriers' Air Operator Certificate (AOC), specifying what kind of business they were allowed to be engaged and what type of routes they were entitled to operation. For example, Air China, the only national flag carrier, inherited all the international traffic rights from CAAC, was entitled to engaging both passenger and cargo operations and operating on both domestic and international routes but with a main focus on long haul destinations in the US and Europe. China Eastern was given the right to operate on both domestic and international markets but with a small number of long haul international routes to the US in addition to a few East Asian countries. China Southern was allowed to operate in both domestic and international markets but mainly focusing on routes connecting peripheral countries in Southeast Asia. The other three carriers were only permitted to operate domestically within mainland China, without access to Hong Kong or Macau Special Administrative Regions (SARs). With such an arrangement, CAAC was able to make sure that there was little overlap in the route network, thus the interests of each carrier being adequately protected. It would also help to avoid any dispute in international route allocation, as the AOC would not allow non-eligible carriers any undesired international expansion.

In this kind of circumstances, international operations developed only slowly, with bilateral air services agreements being concluded as an element of the national strategy for the establishment and maintenance of diplomatic ties. For example, there were only 25 international routes for Shanghai in 1998 and 18 for Guangzhou, the capital city of Guangdong which was regarded as the powerhouse to the country's export industry (Lei and O'Connell, 2011). The flag carrier was the core consideration for the Government as to whether there would be a need to relax any restrictions in terms of market entry,

capacity and pricing. Reciprocity was the philosophy governing the bilateral negotiations, with arrangements made with foreign counterparts being mainly protectionist and similar on all bilateral markets. The agreement with the US in 1980, allowing double designation of carriers from each side to operate on two routes respectively, was very unique and special at that time, given the fact that there existed no second carrier at all in the market for the Chinese government to designate. It was not until 1992 when China was able to designate China Eastern as the second carrier in the market, which launched the US-bound services with its newly-delivered long haul aircraft.

The shift to a moderately liberalised policy began in the early 1990s, when a spectacular growth in air transport was experienced in the market and more aircraft delivered. Some carriers such as China Southern, China Southwest and China Northern were not happy about their restricted business scopes and started to lobby the Government for international expansion. To satisfy their needs, double designation and flexible capacity arrangements were successfully negotiated, in particular with several Asian countries such as South Korea, Japan and Singapore. However, favourable treatment was only extended to those CAAC-controlled airlines that demanded for overseas expansion, despite the fact that a total of more than 40 airlines of different sizes and capabilities had been operating in the market.

The radical shift towards a more liberalised international air transport policy came after November 2001 when China was admitted WTO membership. The fundamental consideration of CAAC was to deliver its series of important commitments to opening its market and to liberalising its regime in order to meet the WTO rules (Freeman and Lam, 2002). The WTO membership exposed the country fully to the international business environment, where its industry had to compete with those from developed, developing and underdeveloped countries. The Government recognised the urgent need for a regulatory reform in its agenda in order to eliminate barriers to promote free trade. Another impetus was the intention of creating strong SOEs in airlines industry in order to reduce competition, optimise the resources and improve productivity and performance so as to get the industry prepared for international competition.

For the first time in October 2003, CAAC stated explicitly to the international aviation community that its air transport policy was to liberalise the market with a “proactive, progressive, orderly and safeguarded” approach (www.caac.gov.cn). The principle was then written into the Annual Strategic Development Plan for 2004 (www.caac.gov.cn), with CAAC advocating its support to carriers that wished to expand into international and regional markets. An assessment mechanism for international market entry and exit was established (www.caac.gov.cn) with an aim to effectively allocate, manage and monitor the implementation of the international air traffic rights. In the same year, Hainan Province was allowed unlimited 3rd, 4th and 5th freedom traffic operations, and Xiamen and Nanjing 5th freedom cargo operations by both Chinese and foreign carriers, though only on a pilot basis, with the primary objective being to facilitate the local economic development while at the same time to earn time for CAAC to justify the political, economic and social impact of the liberalisation policy on the industry and the society as a whole.

To further reinforce its stance that liberalising the country’s international air transport market was its firm and long-term strategic objective, CAAC issued policy guidelines in 2007 stating that international air services would be encouraged to connect Mid-Western and Northeastern regions to the rest of the world. Efforts would be devoted to supporting those carriers which were able to optimise the bilateral air traffic rights available to strengthen aviation relations with African, Central Asian and Latin American countries (CAAC, 2007). Further consolidation of the airline industry was to be encouraged to enable the formation of larger and more competitive enterprises. The three traffic hubs in Beijing, Shanghai and Guangzhou were to be developed and strengthened.

Although air transport has been instrumental in facilitating China’s regional development and export-oriented economic growth, the lack of clear, coherent and well articulated policy objectives in terms of international air transport before 2003 left the country’s airline industry unable to develop a competitive edge compared to their counterparts in their neighbouring countries , let alone carriers in the US and Europe.

The case-by-case approach adopted in bilateral ASA negotiations enabled the Government to be flexible in adjusting its strategies and tactics (Forsyth et al, 2006) to optimise outcomes in light of the prevailing situations but also resulted with a circumstance where, to some extent, the Government has had to accept the outcome of negotiations as a result of competing considerations. Reciprocity has, above all, been the key principle in the bilateral negotiations, dictating the outcome of the discussions. Of the 110 ASAs China had signed by the end of 2007, only 28 contained more relaxed traffic rights allowing multiple designation and unrestricted capacity (www.caac.gov.cn). East and Southeast Asian countries, including Japan, South Korea and Singapore, were among those that enjoyed more relaxed air transport terms of trade with China. African countries were also granted no restrictions in terms of designation and capacity for both passenger and cargo operations, including 5th, 6th and 7th freedom traffic rights (www.caac.gov.cn). The ASA with the US, following the successful conclusion of the 2004 and 2007 Protocols, allowed the phasing in of multiple designation, freedom of commercial arrangements and elimination of restrictions on cargo operations. The two protocols served as milestones, taking China's international air transport liberalisation process into a new era.

Nevertheless, China's liberalisation efforts were recognised by IATA in 2005, which appreciated China's commitment to "progressively liberalising the aviation market and the work to harmonise the air traffic control with global standards" (IATA, 2005). The approach was also welcomed by the US, with the Secretary of the Treasury Henry M. Paulson Jr. (2008) commenting that China's growth and stability depended on moving forward with liberalisation, despite resistance from its domestic industry, rather than economic nationalism which would have an adverse impact on the economy of both the US and China.

5.4 The impact of the policy change on the market structure

5.4.1 Before 2002

Chinese airlines began taking shape after 1987 when CAAC responded to the call of the central government that the industry be corporatized. The monopoly of air transport by CAAC was broken up, with seven carriers being formulated. The objective of the spin-

offs was to enable CAAC to focus on developing its administrative roles in regulating the market, while at the same time, allowing the industry to grow as a commercial business to serve the needs of the society and economy. The newly-formed airlines, thus, became profit-seeking entities responsible for their own operations and performance. As traffic demand accelerated, another 36 airlines had been set up across the country, bringing the total number of carriers to 42 in 1993, carrying 33.83 million passengers and realising 5.12 billion RPK.

The booming of the airlines had completely transformed the market structure. The dominance of CAAC's seven carriers was shattered, resulting in a fragmented market with fierce competition at national level. According to Zhang et al (2004), in 1992, the three CAAC-controlled carriers, Air China, China Eastern and China Southern, were able to take a combined 66 percent of domestic market share, which fell to 56 percent in 1996. Among them, Air China's market share fell sharply from 32 percent to 25 percent for the same period (Table 5.4). One of the reasons was that Air China devoted more of its capacity to international routes as it was the country's only flag carrier which proudly inherited the majority of the long haul routes from CAAC in 1987. It had to rely on other carriers to disseminate its international passengers to domestic destinations due to its inability to develop a well-designed domestic network to serve its passengers. Another reason was that the non-CAAC controlled carriers based in coastal cities such as Shanghai, Xiamen, and Shenzhen were able to take advantage of the economic reform which stimulated the demand for air travel. With newly introduced Boeing aircraft, these carriers were capable of presenting a brand new image to capture more traffic. A third justification was that, more importantly, these non-mainstream carriers were able to benefit from the rapid growth of the local economy which generated more demand than other cities and regions where the rest of the carriers were based.

Table 5.4 Changes of market shares of major airlines (percentage) between 1992 and 1996.

Airlines	1992	1993	1994	1996
Air China	32.1	30.5	28.2	25.3
China Eastern	16.9	16.9	15.3	13.5

China Southern	16.9	15.6	17.2	16.8
China Southwest	7.1	8.3	9.1	8.9
China Northwest	5.0	5.0	4.0	4.9
China Northern	9.0	8.8	8.3	8.1
The rest	13.0	14.9	17.9	22.5
Total	100.0	100.0	100.0	100.0
Three-firm concentration ratio	65.9	63.0	60.7	55.6
Six-firm concentration ratio	87.0	85.1	82.1	77.6

(Remarks: The three-firm concentration ratio is the total of the market shares of the three largest firms while the six-firm concentration ratio is that of the market shares of the three carriers plus China Southwest, China Northwest, and China Northern).

Source: Adapted from Zhang et al., (2004)

Recent studies by Lei and O’Connell (2011) have revealed that fiercer competition existed at national level between 2000 and 2002. Using the Herfindahl index to determine the impact on the industry structure in the market based on the 50 busiest domestic routes, they have found that the number of effective competitors at the national level increased from 6.6 in 2000 to 7.2 in 2002 and further rose to 7.9 in 2009, despite a mild drop to 5.3 in 2003. However, the tough competition did not exist at route level with the Herfindahl index being only around 2.3 in 2000, which gradually rose to 2.9 in 2009.

The relaxation of market entry provided sufficient capacity to satisfy the market demand, but also triggered fierce price competition among the carriers. For example, in 1998, five carriers were allowed to operate between Beijing and Shanghai, which was the busiest domestic route, with China Eastern and Shanghai Airlines being Shanghai-based, Air China Beijing-based and Northwest Airline Xi’an-based. Between January and June 1998, the biggest discount was provided by Northwest Airlines with a discount rate of 68% of the published fare (Table 5.5).

Table 5.5 Price competition on Beijing-Shanghai route, January-June 1998.

Price competition on Beijing-Shanghai route, June 1998		
Airlines	Total number of flights (Jan-Jun 1998)	Average discount rate (%)
Air China	506	40
China Eastern	477	34
Shanghai Airlines	420	25
China Northern	162	59
China Northwest	92	68
Total	1,657	
Daily Frequency	9.1	

Source: Zhang et al., 2004

On the other hand, the rapid traffic growth has not been accompanied by the high rates of profitability. On the contrary, the disorderly price competition brought about overall financial losses to the industry. For the first time during last twenty years since 1978, China's air transport industry recorded a combined loss of 2.1 billion Yuan (US\$3.1 billion) in 1998 (www.caac.gov.cn), which shocked the whole sector. Some blamed the loss on external circumstances such as the financial crisis in Southeast Asian countries which affected traffic demand from international visitors, some complained about the competition in the domestic market, pointing out that the market was distorted due to the number of players in the market, while others criticised the government that failed to regulate the market effectively. Zhang et al. (2004) argued that the profitable operations enjoyed by the industry from 1978 to 1997 were achieved as a result of the rapid economic growth and high demand from the public, while the average return on assets was quite low, which indicated the low productivity and poor management. The golden age of air transport in China would soon be gone should no action be taken to improve its productivity.

5.4.2 Industry consolidation after 2002

The year 2002 saw a second radical structural change of the airline industry in the country initiated by the central government, with three megacarriers being formed out of the ten airlines⁷. The move was again in response to the political call of the central government to transform the industry into a more efficient, competitive and modern sector. By reorganising the resources in the industry, CAAC hoped to optimise capacity, routes, schedule, network and manpower, thus minimising the overall cost. It also hoped that the newly created megacarriers would be able to develop their strengths based on economies of scale so as to enhance their competitiveness in response to the fierce and unhealthy competition of the industry over the previous ten years. Another intention was to create strong SOEs so that they could develop and get themselves prepared for international competition after China's accession to the WTO. The State-Owned Assets Supervision and Administration Commission (SASAC) and Ministry of Finance (MoF), would be responsible for their personnel, assets and financial management, leaving CAAC only responsible for economic and safety regulations as well as negotiating and implementing the international air services arrangements (www.caac.gov.cn).

In order to minimise heads-on competition among the three carriers, the consolidation was strategically designed such that each of them would have its own distinct set of major hubs in evenly scattered geographical locations across the country. The deliberate design of such consolidation was nevertheless criticised by the small- and medium-sized non-CAAC controlled airlines as changing the fragmented market to one of oligopoly where the three giants could leverage more than 80 percent of the market in terms of capital assets. The three megacarriers would have a total fleet of 571 aircraft, dominating the majority of both domestic and international operations. In 2003, the three megacarriers took a combined market share of 70.77 percent measured in passenger and cargo traffic and 64.03 percent measured in RPK and 65.49 percent by RTK. In four years time in 2007, the combined market share of the three megacarriers

⁷ The three big carriers were: Air China taking China National Aviation Corporation, Chengdu-based China Southwest, and Hangzhou-based Zhejiang Airline. China Eastern taking Kunming-based Yunnan Airline and Xi'an-based China Northwest Airline, and China Southern taking Urumqi-based Xinjiang Airline and Shenyang-based China Northern Airline.

increased to 72.87 percent measured by passenger and cargo traffic, 70.36 percent by RPK and 68.25 percent by RTK respectively. Table 5.6 shows the change in the combined market shares of the three megacarriers as well as Hainan Airline between 2003 and 2007. When measured by RPK in international market, the three megacarriers collectively dominated 96 percent market share in 2006 compared with 92 percent in 2000 (Lei and O'Connell, 2011). Their improved market performance was also reflected in their world rankings as Air China positioned 16th, China Southern 18th and China Eastern 23rd in 2008, compared with 30th, 38th and 46th respectively in 2002 (Airline Business, 2003b; Airline Business, 2009).

Table 5.6 Changes of market shares of major airlines between 2003 and 2007.

	Traffic		RPK		RTK	
Year	2007	2003	2007	2003	2007	2003
Air China	26.51%	30.45%	18.76%	20.61%	23.24%	25.76%
China Eastern	21.12%	16.57%	21.08%	19.65%	23.39%	17.96%
China Southern	25.24%	23.75%	30.52%	23.77%	21.62%	21.77%
Hainan	6.36%	6.52%	8.06%	8.62%	4.96%	5.70%
The rest	20.78%	22.72%	21.59%	27.35%	26.79%	28.82%
Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Three firm concentration ratio	72.87%	70.77%	70.36%	64.03%	68.25%	65.49%
Four firm concentration ratio	79.23%	77.29%	78.42%	72.65%	73.21%	71.19%

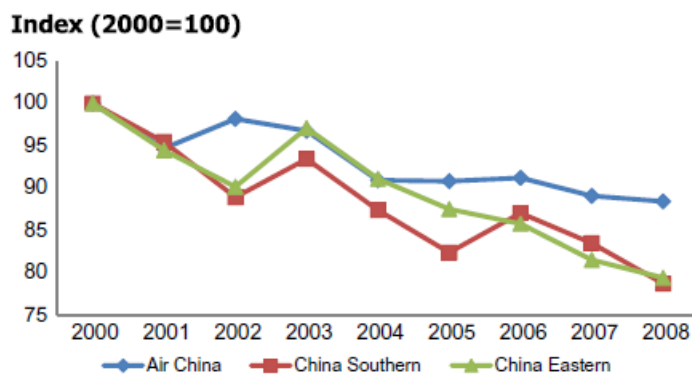
(Remarks: The three-firm concentration ratio is the total of market shares of the three megacarriers while the four-firm concentration ratio is that of the market shares of the three carriers plus Hainan Airlines).

Source: CAAC Statistical Yearbooks 2004 and 2008

Despite the deliberate efforts of the government in minimising the competition, intensified competition was still apparent at route level between the three megacarriers. Taking the operations in the years 2009 and 2000 as examples, the number of overlapping routes between Air China and China Southern was increased to 35 in 2009

from 8 in 2000; the duplicate routes between Air China and China Eastern rose to 27 from the previous 5; while the number of replicate routes between China Southern and China Eastern swelled to 30 from the former 7 (Lei and O'Connell, 2011). The competition resulted in deteriorating yield of the megacarriers from 2003 to 2008, with China Eastern suffering a tremendous operating loss from 2006 (Figure 5.5) (Lei and O'Connell, 2011).

Figure 5.5 Index of real yield in the domestic market, 2000-2008.



Remarks: Real yield is operating revenue divided by RPKs, then deflated by Consumer Price Index (CPI).

Source: Lei and O'Connell, 2011

The consolidation created an opportunity for the three megacarriers to adopt a hub-and-spoke system for an optimal network reach. Before 2002, Chinese carriers mainly operated on a point to point basis, focusing on price competition, service improvement and safety enhancement. Hub-based network planning was quite new and hub-and-spoke was a term used to understand the competitiveness of international carriers in the US and EU markets. After the restructuring, Air China became a multiple hub network operator gradually strengthening its hubs in Beijing, Chengdu, Chongqing, Hangzhou and Guiyang, compared with its previous single hub strategy based only at Beijing. China Eastern developed its hubs in Shanghai, Wuhan, Nanjing, Kunming and Xi'an, while China Southern expanded in Guangzhou, Shenyang, Changsha, Dalian and Haikou (Shaw et al., 2009).

The consolidation and the strategies adopted by the megacarriers helped to strengthen their dominant status in the domestic market, although they were not yet competitive internationally. As the Minister of CAAC, Mr. Li Jiaxiang, commented that “the internal integration has not been accomplished to its full extent, with the management model and operational mechanism still being left far behind compared with their international counterparts. No competitive edge has yet been developed to enable the large carriers to be well positioned for the dynamic changing environment” (Li, 2009). There is quite a long way to go for Chinese carriers to be capable of competing internationally and now it is up to them to decide how to play in the international market.

5.4.3 New wave of competition

The consolidation did not stop the new comers from entering into the industry. In 2004, when the central government encouraged private capital to be invested in key industries, air transport became one of the sectors that attracted significant amounts of fresh private fund from both home and abroad. Market entry was relaxed with dozens of new airlines being approved, bringing once again the total number of the carriers to 41 in 2009, almost the same amount as that in 1993. In addition, the business scope of some of the airlines was expanded, with international operations allowed. New capacity was added and market entry restrictions on domestic routes were removed, thus resulting in a new surge of competition.

Of the 41 airlines that are operating to date, 8 are licensed for both domestic and international passenger and cargo operations, 25 for domestic operations, with the remaining 8 for purely cargo operations. Of the 8 international carriers, Air China, China Eastern (including Shanghai Airlines), China Southern and Hainan Airlines are authorised for both short- and long-haul operations, while the rest including Xiamen Airlines (China Southern has a 60 percent stake), Sichuan Airlines (39 percent stake held by China Southern, 10 percent by Shanghai Airlines), Shandong Airlines (23 percent stake by Air China) and Shenzhen Airlines (51 percent stake held by Air China) are licensed for short haul operations to neighbouring countries in East and Southeast Asia.

The complicated ownership structure of these carriers allows them to be tied closely to one of the big three airlines. It also ensures that each is crystal clear about their market segmentation, which adversely refrains them from expanding into the long haul international market. The fleet of these carriers are mainly composed of Boeing 737, 757, Airbus 310 and 320 aircraft, which will not allow them to operate in long haul markets.

Of the 25 domestic carriers, most are new start-ups such as Spring Airlines and Juneyao Airlines that were set up after 2004, being authorised to operate on inter-provincial routes. Based in Shanghai and competing with China Eastern and Juneyao Airlines, Spring Airlines relies on its extensive distribution outlets in high streets across the country to secure passenger bookings to ensure high load factors. The low cost business model featuring Chinese characteristics works well for Spring Airlines which is steadily expanding its routes network across China and market share in Shanghai. In 2008, the airline carried 2.9 million passengers with 355.4 million RPK. In 2009, the carrier was approved by CAAC to expand into South Korea, Japan, Russia, Hong Kong and Macau.

Of the 8 cargo carriers (Table 5.7) that are all licensed for international operations, 4 are derivatives from their parent passenger operations which have been in service for quite some time. The other 4 are comparatively new start-ups being specifically set up as joint ventures between Chinese companies and foreign investors in response to the surging demand for cargo transport between China and the rest of the world. Being equipped with Boeing and Airbus freighters, the all-cargo carriers mainly target international long-haul markets in the US and EU.

Table 5.7 China's all-cargo operators.

	Chinese shareholder	Foreign stake	Establishment	Base
Air China Cargo Co Ltd ⁸	Air China	Cathay Pacific	2003	Beijing and Shanghai
China Cargo Airlines	China Eastern	China Ocean Shipping Group	1998	Shanghai

⁸ Re-launched in March 2010.

		Company		
China Southern Cargo	China Southern	N/A	1988	Guangzhou
Shanghai Airline Cargo	Shanghai Airline	Eva Air	1986	Shanghai
Yangtze River Express	Hainan Airlines	China Airlines and others	2004	Shanghai
Jade Cargo International	Shenzhen Airline	Lufthansa Cargo	2006	Shenzhen
Great Wall	China Eastern	Singapore Airlines	2004	Shanghai
Grand Star	Sinotrans Air Transportation Development Co.	Korean Air and Hana capital Co. Ltd	2007	Tianjin

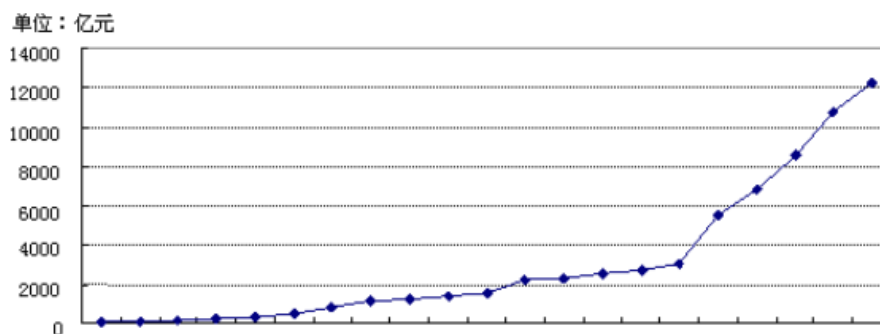
Source: compiled by the author from the carriers' website

Ernst and Naughton (2008) have divided Chinese industries into a three-tier structure, namely tier one, which is large, central government controlled firms; tier two, which consist of medium-sized forms partly owned by local government and private capitals; and tier three, that is made up of small-scaled private firms. Applying the above criteria to airline industry, it can be accepted that majority of Chinese airlines fall into tier one and tier two categories. Over the years, the continuous political and economic reforms have not changed this peculiar characteristic which it shares with other key industries such as steel, telecommunication and shipping, namely that it has been the large state-owned companies that collectively have taken a dominant position in the market (Kennedy, 2005). They have their own core business of operation and possess many dozens of supportive subordinate industrial enterprises. The come-and-go of some small and medium-sized late comers in the market have never been able to shake the monopoly of the giants, who have the political, financial, infrastructural and personnel support from all sources available, nor have they been able to bypass these giants to get any favourable policy or treatment from the regulator. It is these giants that have the access to government policy makers and resources to influence the policy making process.

5.5 Chinese airports and their performance

Infrastructure including airports, highways and railways has received magnificent amount of investment in China since 1978. According to CNSB, around 6.4 billion Yuan (US\$94 million) was invested in all transport modes in 1978. The figure jumped to 1.2 trillion Yuan (US\$181 billion) in 2007, which was 193-fold increase (Figure 5.6).

Figure 5.6 Investment in all transportation modes from 1978 to 2007 (The unit is 0.1 billion Chinese yuan).

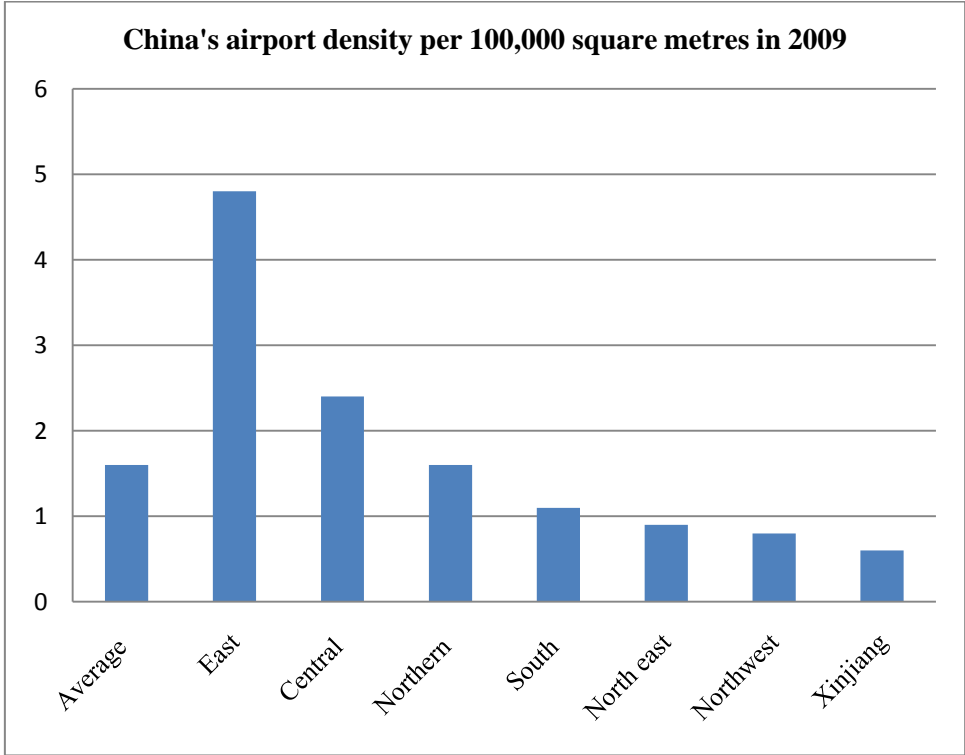


Source: www.stats.gov.cn

In terms of air transport, about 131.1 million Yuan (US\$14.7 million) was invested in 1980 in airport construction. The figure went up to 10.6 billion Yuan (US\$1.2 billion) in 2003 and then 30 billion Yuan (US\$4.3 billion) in 2008. The investment brought more civil airports into operation. In 1980, there were 80 airports for civilian use with one airline (e.g. CAAC) operating on 159 domestic routes. In 2007, there were 148 licensed civilian airports connecting 146 domestic cities with a total passenger throughput of 387.6 million, representing 16.8 percent increase year on year, and a total freight throughput of 8.6 million tonnes, a 14.3 percent increase (Li & Fung Research Centre, 2009). The increased number of airports has helped to improve the density of airports to 1.6 per 100,000 square metres across China, though still quite low compared with 23.2 airports per 100,000 square metres in Japan. When considering the catchment area of an airport, being measured as 1.5 hour's drive time, China's air transport service only covers 62 percent of the population and 82 percent of its national GDP (Diao, 2010) (Figure 5.6). The imbalance of airport distribution in China is also reflected geographically, with most airports being in Eastern China while few in the western

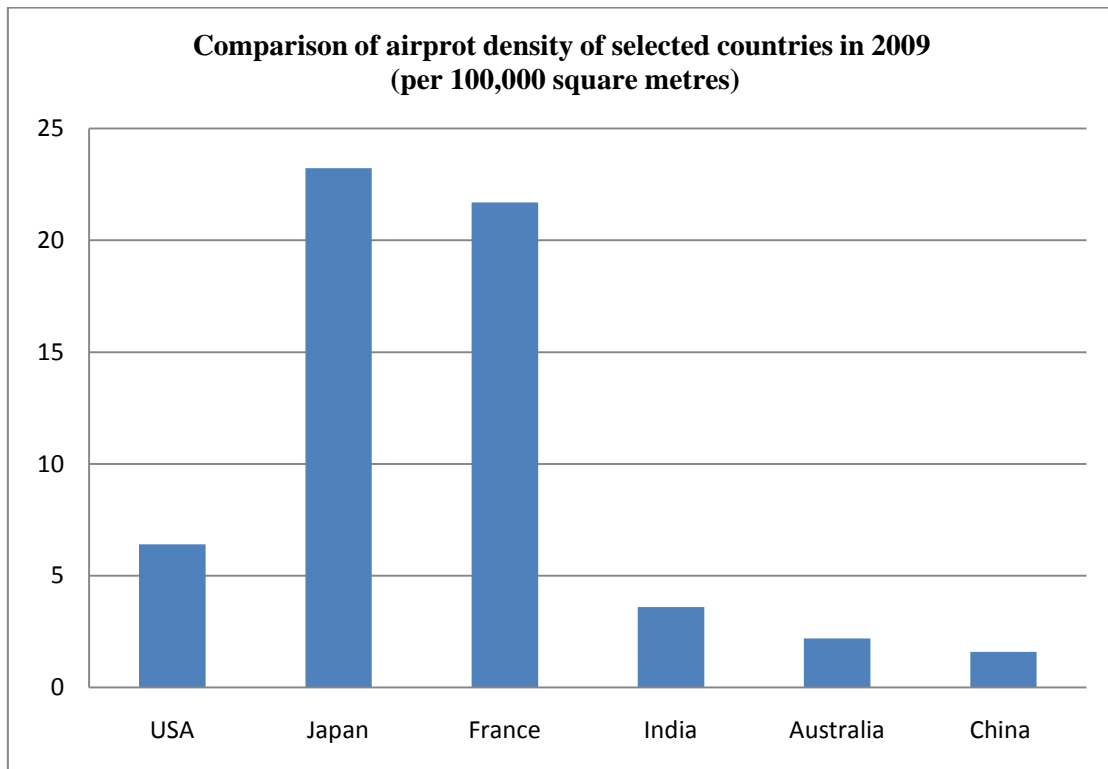
areas, with the density in Xinjiang and northwest China being only 0.6 and 0.8 airports per 100,000 square metres respectively (Figure 5.7) (Diao, 2010). When comparing China with other countries such as the US, Japan, France, India and Australia, its average airport density is much lower than the above countries (Figure 5.8) (Diao, 2010).

Figure 5.7 China’s airport density per 100,000 square metres in 2009.



Source: Diao, (2010)

Figure 5.8 Comparison of airports density per 100,000 square metres between China and a few selected countries in 2009.



Source: Diao, 2010

To improve the situation, in 2010, CAAC announced an investment of 250 billion Yuan (US\$35.7 billion) in airport constructions with an aim of bringing the total number of civil airports to 244 by 2020 (excluding those in Hong Kong, Macau and Taiwan), with the majority of the new airports being built in Western China (Figure 5.9). CAAC believed that increasing fixed-assets investment was crucial to maintaining the industry's long-term sustainable development.

Figure 5.9 Total number of airports by 2020 and their location.



(Remarks: the green dot represents airports that had been operating by the end of 2006, the red triangle refers to the new planned airports for the 11th five year period, while the blue square means the planned new airports for the period of 2011 and 2020. The total number and planning does not cover the Hong Kong, Macau SARs and Taiwan.)

Source: www.caac.gov.cn

Among the 148 airports that were in operation in 2007, 47 of them handled more than one million passengers, accounting for 95.4 percent of the total, with Beijing Capital International Airport (BCIA) being at the top of the league recording 53.6 million passengers, followed by Guangzhou New Baiyuan International Airport (GBIA) with 31 million and Shanghai Pudong International Airport (SPIA) 28.9 million. In terms of cargo transport, SPIA took the lead reporting 2.6 million tonnes of freight followed by BCIA with 1.4 million tonnes.

In 2009, a total of 166 commercial airports were open for civilian operations in China, which altogether handled 486 million passengers and 9.5 million tonnes of cargo. Among them, 51 handled more than one million passengers, with 14 receiving more than 10 million, accounting for 52.1 percent of the national total (Table 5.4). BCIA remained champion of the league reporting 65.4 million passengers, followed by GBIA

with 37 million and SPIA 32 million. In terms of cargo, SPIA ranked first, followed by BCIA and GBIA, which collectively handled 57 percent of the national total. The most phenomenal growth comes from those medium-sized airports such as Chengdu, Changsha, Sanya, Harbin and Guiyan which registered a growth rate of above 30 percent.

Table 5.8 Top 14 airports measured by passenger and cargo throughput in 2008 and 2009.

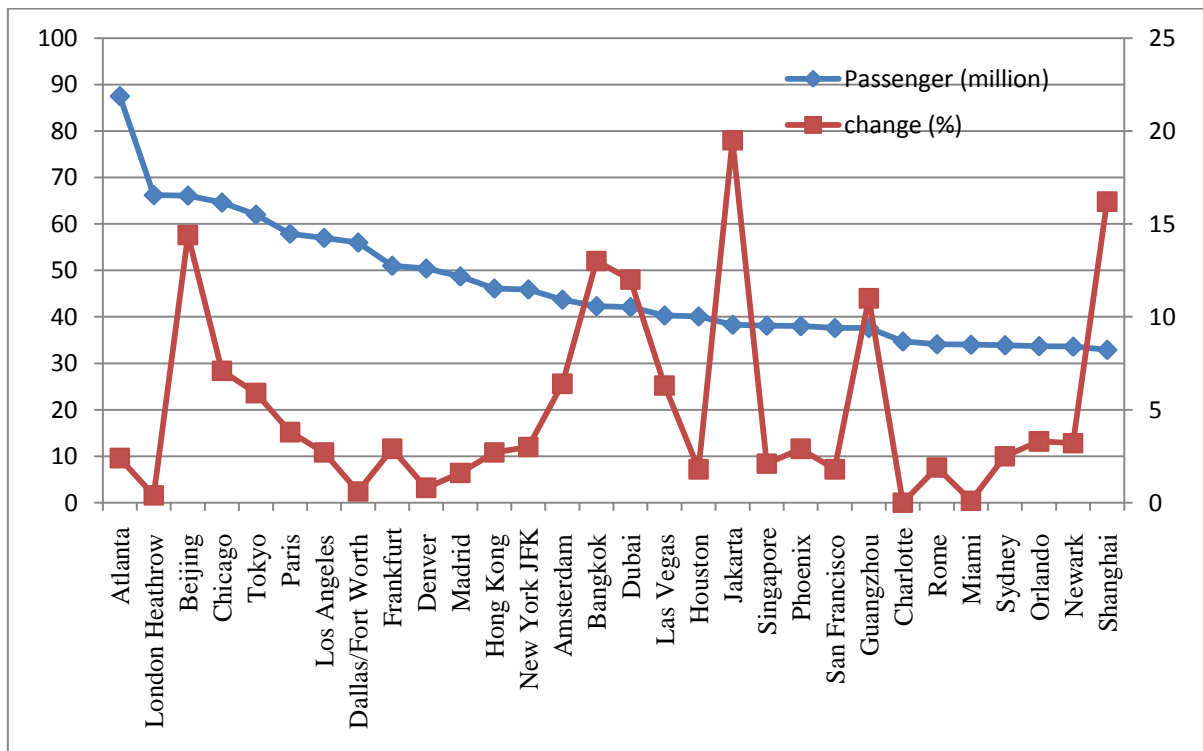
Airport	Passenger throughput (million)				Freight (thousand tonnes)			
	rank	2009	2008	change	Rank	2009	2008	change
Beijing	1	65.4	55.9	16.9%	2	1,475.70	1,367.70	7.9%
Guangzhou	2	37	33.4	10.8%	3	955.3	685.9	39.3%
Shanghai Pudong	3	31.9	28.2	13.1%	1	2,543.40	2,603.00	-2.3%
Shanghai Hongqiao	4	25.1	22.9	9.6%	5	439.1	415.7	5.6%
Shenzhen	5	24.5	21.4	14.4%	4	605.5	598	1.2%
Chengdu	6	22.6	17.2	31.3%	6	373.5	373.1	0.1%
Kunming	7	18.9	15.9	19.3%	7	258.8	236.3	9.5%
Xi'an	8	15.3	11.9	28.3%	14	127	117.1	8.5%
Hangzhou	9	14.9	12.7	17.9%	8	226.3	210.8	7.4%
Chongqing	10	14.3	11.1	26.0%	11	186	160.3	16.1%
Xiamen	11	11.3	9.4	20.7%	10	196	195.5	3.0%
Wuhan	12	11.3	9.2	22.8%	17	101.9	89.9	13.4%
Changsha	13	11.3	8.5	33.5%	18	87	71.2	22.3%
Nanjing	14	10.8	8.9	22.0%	9	200.1	187.6	6.7%

Source: www.caac.gov.cn (15th Feb. 2010)

The achievement was reflected in ACI's world's busiest airports league. In the 1980s and 1990s, none of the Chinese airports were listed in the world's top 30 airports in terms of passenger and cargo traffic. The first time that a Chinese airport appeared in the league was in 2002 when BCIA was ranked 26th, with a total passenger throughput of 27.2 million. In 2005, BCIA jumped to 15th place with a record number of 41 million

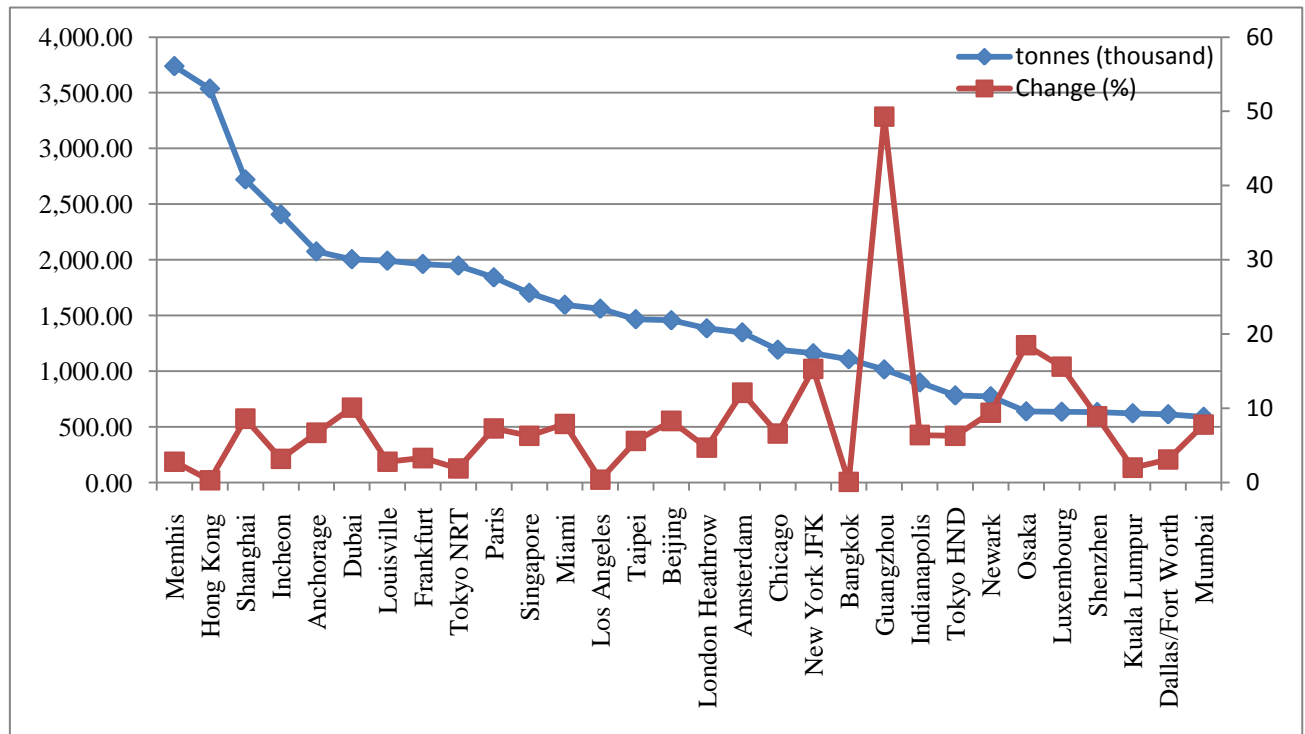
passengers. In 2009, both BCIA and GBIA were in the league table, with BCIA taking the third place, GBIA in 23rd place, and Shanghai Pudong the 30th. Figure 5.10 and 5.11 show the top 30 airports in terms of passenger and cargo traffic respectively for the last 12 months ending February 2010.

Figure 5.10 Top 30 airports for the last 12 months ending February 2010 measured by passenger throughput.



Source: www.aci.org

Figure 5.11 Top 30 airports for the last 12 months ending February 2010 measured by cargo volume.



Source: www.aci.org

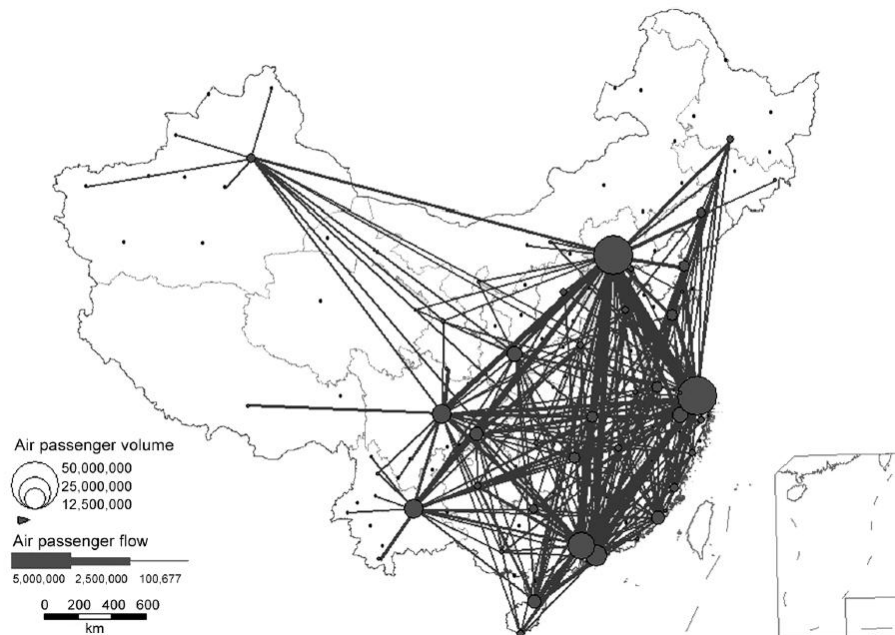
5.6 China's three strategic cities, their airports as main hubs and the home carriers

Beijing, Guangzhou and Shanghai, strategically located at the North, South and East of the territory, are traditionally considered the most important cosmopolitan cities both politically and economically, which still holds true today. Beijing, the country's capital, has been an international gateway since China has ever had its international operations. Its close proximity to the Bohai Sea via Tianjin, a historical and modern industrial city focusing on aviation and aerospace, has created a Beijing-Tianjin Economic Zone and is one of the key economic drivers for Northern China. Guangzhou is at the far end of China's southeast coastline at the mouth of the Pearl River, with proximity to Hong Kong and Macau. Sharing a lot of cultural features, Guangzhou, together with Shenzhen and Zhuhai in the Pearl River Delta (PRD) region, has evolved into a metropolitan interlocking region linking a network of cities (Williams, 2009), thus creating an

unrivalled competitive edge for its economic growth. Being the first in setting up special economic zones and maintaining its robust economic growth over the last 30 years, Guangzhou and the PRD region boast to be the global workshop and centre of electronics and pharmaceutical products. Shanghai is the most commercialised city in China and has always been enjoying its prosperity as the country's business centre. Sitting at the mouth of the Yangtze River, the city, together with other major industrial cities in its catchment area including Hangzhou, Nanjing and Suzhou, has also formed a metropolitan region and has acted as one of China's economic powerhouses since 1978. In addition, as one of the biggest sea ports of the world, Shanghai is advantageous in being able to integrate all transport modes with the potential to be a real intermodal hub in the Asia Pacific region.

As discussed in previous sections, the development of China's air transport industry reflects the country's economic conditions, with the Eastern and Southern coastal provinces, centred on the above three big cities, having been enjoying rapid growth and prosperity. Since the 1980s, the three big cities have taken a high proportion of market shares of passenger traffic, accounting for roughly 37 percent of all passenger flows (Wang and Jin, 2007). Of all the international routes, more than 90 percent originate from or terminate at these three cities. In 2008, Hainan Airline alone launched 6 international services to Seattle, Irkutsk, Bishkek, Bombay, Toronto, and Berlin, all of which originated from Beijing. China Eastern launched Shanghai to Saipan, Bombay, Johannesburg and Copenhagen routes, while Guangzhou became the destination for Qatar Airways from Doha, Emirates from Dubai, and Kenya Airways from Nairobi (www.caac.gov.cn). The three cities have formed a golden triangle (Williams, 2009) that has become the backbone of the country's economy and air transport (Figure 5.12).

Figure 5.12 Air traffic volume of the three big cities in 2005.



Source: Wang and Jin (2007)

5.6.1 BCIA and its home carriers

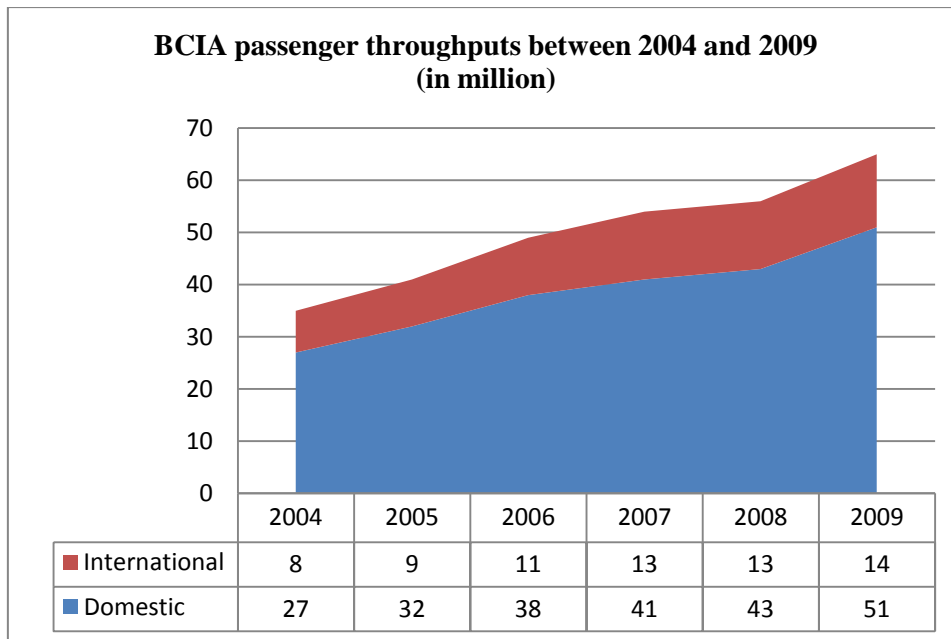
5.6.1.1 BCIA

BCIA is branded as the “Prime Gateway” to China. With two class 4E runways and three terminals, the airport hosts more than 70 airlines serving 106 domestic cities and 85 international destinations. Although being listed on the Hong Kong stock exchange market since February 2000, the airport, being excluded from the government’s “airport localisation scheme” which transferred all the airports to local authorities in 2003, remains under the direct control of CAAC. Over the years, the airport has led the way in generating both passenger and cargo traffic, making itself by far the largest airport of the country, followed by Guangzhou, Shanghai Pudong, Shanghai Hongqiao and Shenzhen. In 2009, the airport welcomed 65.4 million passengers, with profits of 30 billion Yuan (US\$4.4 billion), accounting for 14 percent of the national total (www.bcia.com.cn).

With a designed maximum handling capacity of 85 million passengers per annum for the three terminals combined, the airport is now very concerned about its current space available for further expansion. To ease the traffic pressure, a second airport about 40 kilometres south of Beijing has been proposed for construction with an estimated investment of \$13 billion to be completed in 2015. The new airport is anticipated to handle exclusively the burgeoning domestic traffic to and from the city and its catchment area, which, to some extent, will take away a significant number of passengers at the current airport. With a designed handling capacity of 60 million passengers per annum, the new airport will enable Beijing to become the second city in China (after Shanghai) to operate with two major civilian airports within the city boundaries.

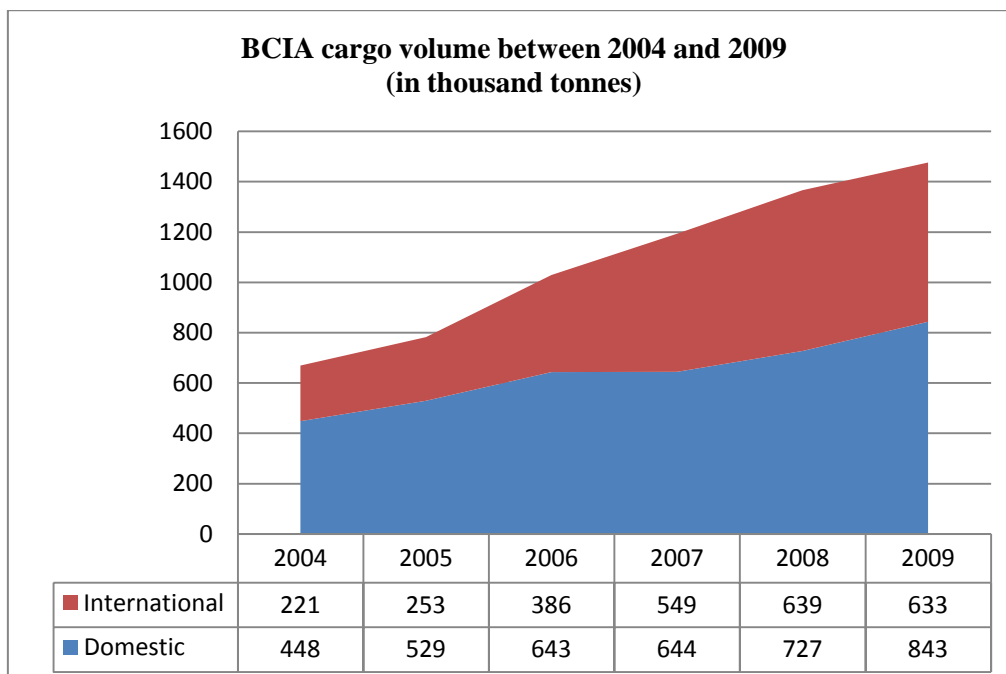
Although with a vision of becoming the foremost national gateway, the airport has been seeing a much faster growth in domestic rather than the international traffic over the decades. Figure 5.13 provides the passenger traffic that has been handled at the airport between 2004 and 2009, with a breakdown of its domestic and international operations, which reveals that the gap between the two categories remains unchanged. In 2004, domestic passenger traffic was 26.6 million, with international being 8.3 million. By 2009, the domestic traffic increased to 51.3 million while international traffic only moderately grew to 14.1 million. In terms of cargo (Figure 5.14), by contrast, the international freight is increasing faster than domestic freight. In 2009, the airport handled 663 thousand tonnes of freight, a three times increase compared with that in 2004, when the airport handled only 221 thousand tonnes of freight. Compared with other Asia hubs such as Hong Kong, Incheon, Tokyo and Singapore, the international traffic at BCIA is far less. Figure 5.15 shows the international passenger throughput of the top 30 airports including these Asian airports, where Hong Kong ranks 3rd, Singapore 7th, Tokyo 8th and Bangkok 9th, with Beijing being excluded from the list. One of the arguments for such an imbalanced growth is that the protective bilateral arrangements which treated Beijing specially restrained the airport's traffic growth. Another factor is the limited slot capacity which has affected its potential to accommodate more traffic.

Figure 5.13 BCIA passenger throughputs between 2004 and 2009.



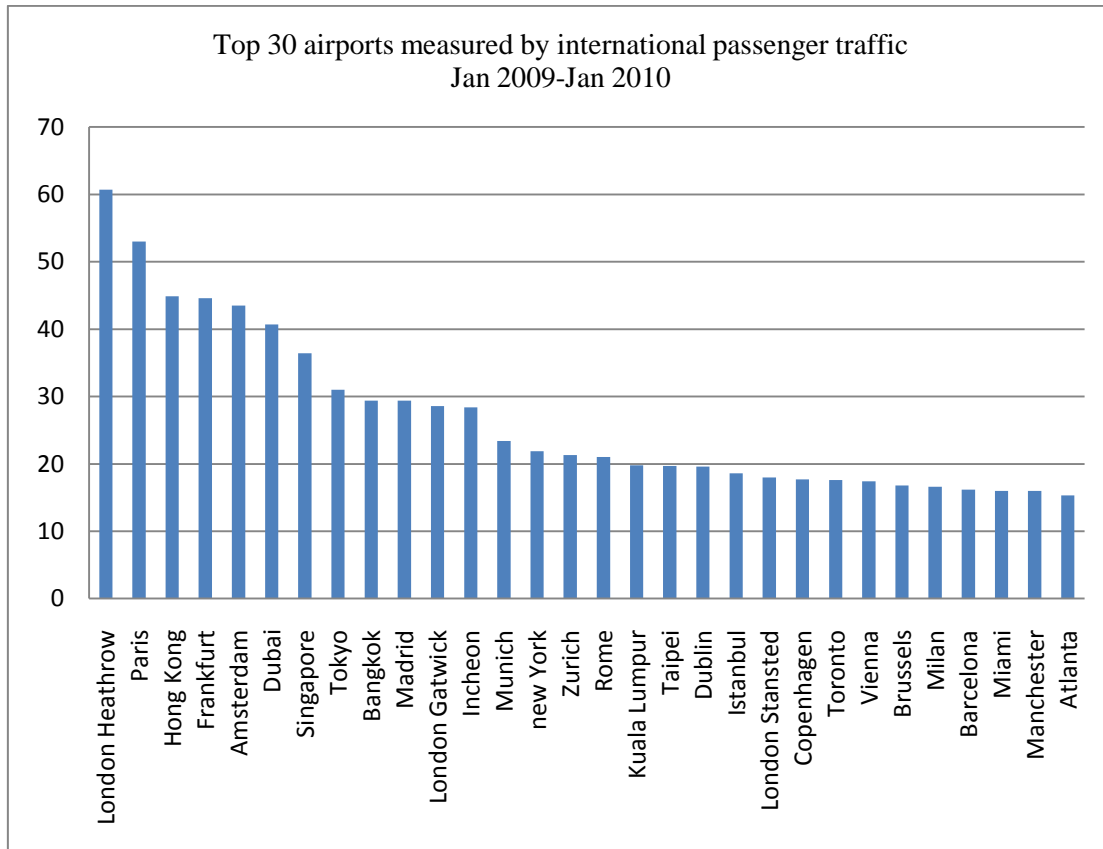
Source: compiled by the author from various version of BCIA annual report

Figure 5.14 BCIA cargo traffic between 2004 and 2009.



Source: Compiled by the author from various versions of BCIA Annual Reports

Figure 5.15 Top 30 airports measured by international passenger traffic, Jan 2009-Jan 2010.



Source: www.aci.org

Geographically, Beijing is ideally located as a hub connecting North America, Europe, and Northeast and Southeast Asia, as it is closer to North America on the trans-Pacific routes than Shanghai, Seoul, Tokyo, Taipei, Hong Kong and Singapore. It is also better positioned on the Northeast/Southeast Asia-Europe routes than Shanghai, Incheon, Tokyo and Osaka. Within five hours' of flight time from Beijing, the population that can be served is about 2 billion, with most cities in East Asia being covered (Zhang et al., 2004). Economically, Beijing together with Tianjin is one of the most important industrial zones hosting such industries as financial services, aviation, logistics, telecommunication and IT. The Beijing Statistics Bureau's (BSB) data showed that in 2008 the city's GDP was recorded at \$1,048.8 billion with \$9,075 per capita, 655 times

more than that in 1978, which was 10.9 billion Yuan (\$1.6 billion) with \$797 per capita. Its international trade value stood at \$271.7 billion in 2008 compared with \$297.5 million in 1978 (www.bjstats.gov.cn). The biggest trade of Beijing is with Japan, followed by the US, Germany and Singapore (www.bjstats.gov.cn). From the air passenger's perspective, Beijing is more attractive as a transit airport compared with Shanghai and Guangzhou as more than double the passengers⁹ preferred to choose their connecting flights in 2006-2007 and almost three times more in 2008-09, an almost 60 percent increase, despite the fact that fares transiting via Beijing was much higher than that via Shanghai and Guangzhou. This reflected the willingness of the consumers to use the airport as well as the potential for its base airlines to develop its hub strategies (Lei and O'Connell, 2011).

As the country's capital, the political, economic and cultural centre supported by the adjoining industrial city of Tianjin, Beijing is attractive to both domestic and international carriers. With more than 1400 aircraft movements everyday, the airport is the home of Air China and Hainan Airline. It also serves as the regional hub for Star Alliance, One World and Sky Team (www.bcia.com.cn). The airport fully appreciates its current status and is keen to develop more routes in order to optimise its network so as to develop into the largest airport in the world in the foreseeable future.

5.6.1.2 Air China

Air China was formed in 1988 when the first round of administrative reform in the air transport industry started. As a result of the spin-off of CAAC separating its operational and regulatory functions, Air China acquired majority of CAAC's international routes to all destinations of the world. As a consequence, its domestic network was comparatively underdeveloped resulting in the carrier having to rely on other airlines to distribute its international passengers. In 2002, the government-initiated consolidation enabled the carrier to strengthen its hub in Beijing, while at the same time expanding into Chengdu and Hangzhou with a bigger domestic network to feed its international

⁹ Lei and O'Connell's research showed that in 2006-07, around 1.4 million passengers transferred at Beijing compared with 624,000 transferred at Guangzhou and 781,000 at Shanghai Pudong. In 2008-09, the passengers using Beijing as a transit airport increased to 2.2 million compared with 674,000 in Guangzhou and 730,000 in Shanghai Pudong (Lei and O'Connell, 2011).

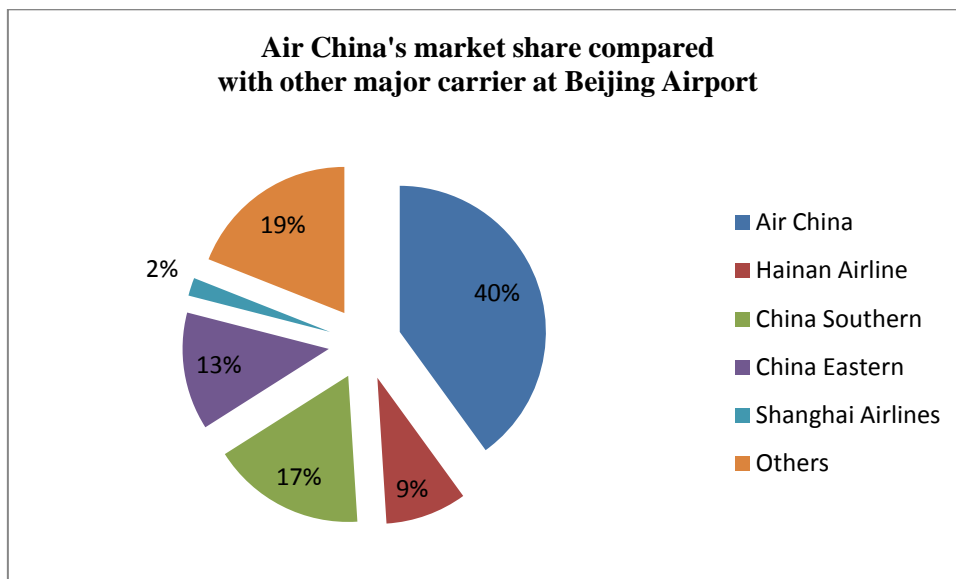
flights (Figure 5.16). With a current fleet of 262 aircraft, Air China operates on 250 routes connecting 87 domestic cities and 56 international destinations in 32 countries and regions. With Beijing as its biggest home base, the carrier takes around 40 percent market share in terms of capacity in 2010 (Figure 5.17). Though being listed on the Hong Kong and London Stock Markets in December 2004, Air China remains one of the top 100 SOEs under the supervision of SASAC and became a Star Alliance member in December 2008.

Figure 5.16 Air China's hubs and domestic route map.



Source: GCW Consulting, 2007

Figure 5.17 Air China's market share at BCIA measured by capacity available in April 2010.



Source: www.centreforaviation.com

Air China has been profitable since 2001 except for 2008, with 4.9 billion Yuan (\$717.8 million) profit being recorded in 2009, a 52 percent increase year on year (www.airchina.com.cn). In 2009, Air China carried 39.8 million passengers and 944 thousand tonnes of cargo, realising 73.4 billion Yuan (\$10.8 billion) of revenue from passenger traffic and 3.5 billion Yuan (\$515 million) of revenue from cargo operations. Table 5.9 reveals Air China's financial performance between 2005 and 2009 demonstrating its healthy financial status and strong growth trend.

Table 5.9 Air China's financial performance between 2005 and 2009 (million US Dollar).

	2005	2006	2007	2008	2009
Passenger revenues	3,862	4,721	5,724	6,260	10,800
Cargo revenues	454	508	539	1,037	515
Other revenues	366	419	475	343	n/a
Total revenues	4681	5,647	6,737	7,640	14,440
Operating result	449	316	485	-276	n/a

Net result	294	338	519	-1,353	718
Net margin	6.30%	5.98%	7.70%	-17.70%	9.44%

Source: www.rati.com

Following its success in stopping China Eastern's collaboration with Singapore Airlines in 2008, Air China adopted a head-on strategy to compete with its domestic rivals, i.e. China Eastern and China Southern. For the passenger market, Air China set up a Shanghai subsidiary, acquired East Star that went bankrupt in 2009 and reconfigured it into a Wuhan subsidiary, secured close to 30 percent ownership of Cathay Pacific and increased its shareholding in Shenzhen Airlines, which is based only 120 kilometres away from Guangzhou where China Southern's home is.

Shenzhen Airlines, ranked 5th largest carrier of the country measured by both domestic and international frequencies from China, plays an important role at Shenzhen airport with 589 weekly departures (summer season of 2009), of which 569 are on domestic routes, 96 percent of its overall network (Table 5.10) (www.routesonline.com).

Table 5.10 Shenzhen Airlines' weekly frequency in summer season 2009.

Carrier	Weekly flights (domestic and international ex China)	Market share
China Southern	9849	22%
China Eastern Airlines	8180	19%
Air China	6107	13%
Xiamen Airlines	3695	8%
Shenzhen Airlines	3085	7%

Source: www.routesonline.com

Although the airline only has 24 weekly international and departures to seven destinations in Southeast Asia including Singapore, Kota Kinabalu, Bangkok, Incheon and special services to Taipei, its domestic network will enable Air China to build a strategic network in the south region of the country and to compete with China Southern, which operates 514 weekly flights from Shenzhen to 40 destinations

(www.routesonline.com). Acquiring Shenzhen Airlines will add 45 new routes to its network, complementing its 485 weekly international departures, 266 of which are served from Beijing (www.routesonline.com). In addition, the carrier increased its capacity in Chengdu to strengthen its regional hub status to capture the southwest China market.

The strategic moves will enable Air China to expand its operations to, and reinforce its presence in, central, eastern and southern China which are traditionally the home territories of China Eastern and China Southern. In commenting on the carrier's stake arrangement with Cathay, Wolf (2009) made the perfect point: "For such a large country, while Beijing makes for an excellent hub feeding into Europe, Russia and North America, it does not make sense for over two-thirds of China's population to fly through Beijing to get to the Middle East, Africa, South Asia, Southeast Asia, Australia, Hong Kong, Taiwan and the South Pacific. To this end, a partnership with Cathay will leave Air China free to concentrate on the areas that will make the most money in the long run, e.g. turn its attention particularly to optimize its domestic route structure to feed into its international hubs, improve the efficiency of its fleet and its operations, and continue to improve service on the routes it has. At the same time, it will be able to build its route system and the know-how to compete against global carriers. Even better, Cathay remains the competitive foil to sustain pressure on other premium Asian carriers while Air China matures".

For the cargo market, Air China Cargo (ACC) was launched in 2003 as a wholly-owned subsidiary of Air China based on the carrier's cargo arm. With a fleet of eight B747 freighters in service and two TU204 to be delivered in 2011, Air China Cargo has dedicated itself to the international market, operating to 14 destinations including Tokyo and Singapore in Asia; Anchorage, Los Angeles, New York, Portland and Chicago in the US; and Paris, Frankfurt, and Manchester in Europe from both Beijing and Shanghai.

In February 2010, Air China Cargo sold 25 percent of its shares for \$249 million to Cathay to re-launch the operation based in Shanghai, so that it could leverage its strength in Beijing to secure the market of northern China, while at the same time

establish a threshold in Shanghai, where China Cargo Airline (CCA), a joint venture of China Eastern, is based, to capture the freight market in the Yangtze River Delta region (YRD).

“The strategic partnership with Air China to form a strong home-based cargo airline with a firm foothold in the YRD region will ensure an efficient capture of cargo movements that may otherwise divert to rival hubs in the region”, claimed Cathay’s Chairman Christopher Pratt (www.cathaypacific.com). “The ACC will fully capitalize on both companies’ existing brand strengths and shareholders’ support to capture business opportunities, maintain leadership position in the market and contribute to the development of the Beijing and Shanghai aviation hubs” asserted Air China Chairman, Mr. Kong Dong (www.cathaypacific.com).

Cathay, as part of the deal, injected four Boeing 747-400 freighters and two spare engines to enlarge the fleet for international expansion. The transaction received regulatory approval from the European Commission in June 2010 to enter into the European market, which confirmed that the combined market share of Air China and Cathay on the relevant routes between Asia and the European Economic Area (EEA) was limited due to its complementary nature, thus clearing the way for the new joint venture to expand in both fast-growing China and Europe.

5.6.1.3 Hainan Airlines

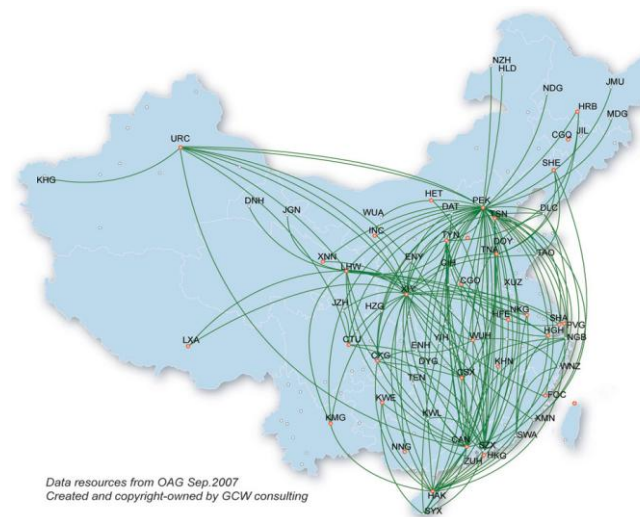
Unlike other megacarriers, Hainan Airlines is a non-government owned airline with its corporate base in Haikou¹⁰, the capital of Hainan Province. Registered in 1989 with the local provincial government, the airline did not start operations until 1993 when its first aircraft was delivered. The carrier was restructured in 1995 on receipt of an international investment which made it the first joint-ventured air transport enterprise, being able to finance its fleet for more commercial operations on trunk routes. The airline was renamed Hainan Airlines Company Limited (HNA) in 1997 and became the first Chinese carrier to have interest in an airport with the purchase of a 25 percent stake in Haikou Meilan International Airport. It started regional services from Sanya to

¹⁰ The carrier planned to move its corporate head office to Beijing in 2010.

Macau in 2000 and launched a Budapest service from Beijing in 2004, the first of the carrier's international long haul routes.

With its operational hubs in both Beijing and Haikou, the airline operates on more than 500 routes connecting 90 cities in China and to 19 international destinations in Russia, Japan, Africa and Europe, originating from Beijing with a fleet of 69 aircraft (Figure 5.18 shows the carrier's domestic route network in 2007. In 2009, it carried 17.9 million passengers with 28 billion RPK and 3.1 million RTK. Table 5.11 provides the carrier's operational results between 2005 and 2009.

Figure 5.18 Hainan Airlines' domestic route network 2007.



Source: GCW Consulting, 2007

Table 5.11Hainan Airlines' operational results between 2005 and 2009 (in million).

Operational results	2005	2006	2007	2008	2009
Passenger carried	13	14	15	15	18
RPK	17,205	20,178	21,691	22,850	28,328
ASK	22,976	26,764	27,074	29,185	36,744
RTK	1,810	2,141	2,248	2,366	3,016

Source: www.rati.com

Compared with others major carriers, Hainan Airlines was disadvantaged in terms of operational experience and state-aid accessibility. To bypass the competition, the carrier has chosen secondary airports in Europe, America and Africa, such as Brussels, Budapest, Berlin, Seattle and Rwanda to develop its international network. Furthermore, it acquired Hong Kong Airlines in 2008 so as to be able to operate services from Hong Kong to more Southeast Asian countries, which bypassed the restrictive bilateral arrangements between mainland China and the countries concerned.

5.6.2 New Guangzhou Baiyun International Airport (GBIA) and other airports in the PRD region

5.6.2.1 PRD region and its export-oriented economy

The PRD is named after its physical characteristics occupying a total area of 8,600 square kilometres along the Pearl River estuary where the river flows into the South China Sea (Miu, 2005). From the economic perspective, the region is defined to include such major cities as Guangzhou, the capital of Guangdong Province, Shenzhen, Dongguan, Foshan, Zhongshan and Zhuhai from the mainland Chinese side and Hong Kong and Macau SARs (Figure 5.19).

Figure 5.19 The Map of the PRD.

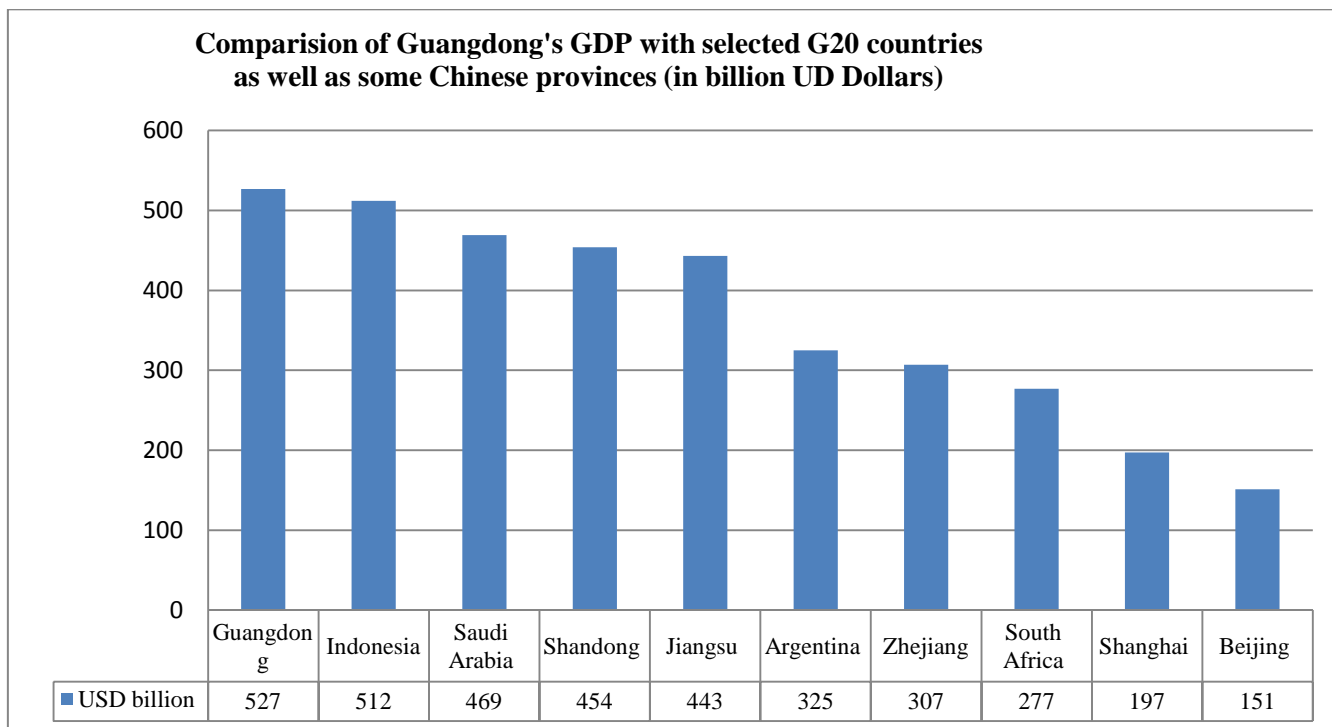


Source: Miu, 2005

The proximity to Hong Kong and Macau gives Guangzhou and hence the province an unrivalled advantage. Historically, the people in Guangdong have very strong overseas connections due to their family relations whose interaction has remained active over the centuries. The same language and customs practice shared with Hong Kong, Macau and Southeast Asia bring them closer to each other. Such a cultural link was the preliminary justification for the central government to allow the set-up of Special Economic Zones (SEZ) in Shenzhen, Zhuhai and Shantou in the province with special policies, which was the first of its kind in China. Aiming at attracting investment from overseas Chinese and importing new technology, these cities were given considerable autonomy in formulating their own regulations in running businesses and levying taxes. The special policies resulted in a spillover effect to the whole province, which received a significant amount of foreign direct investment with tremendous export-oriented labour-intensive manufacturing facilities being established, which in turn provided an unprecedented linkage to international markets. Of those tens of thousands of small and medium sized enterprises in the region, more than 70 percent are engaged in export manufacturing.

Guangdong soon became the wealthiest province in China and the region became a major driver for China's economic growth and a platform for the country's growing integration into the global economy (Miu, 2005). Between 1978 and 2001, its GDP had grown at an average of 12.1 percent per annum, compared with the 9.5 percent national average (Ljungwall, 2004). In 2002, its GDP was \$113 billion, and jumped to \$450 billion in 2007, with an average annual growth rate of 14.5 percent (www.newsgd.com). The GDP per capita in 2007 reached \$4,000, compared with \$50.00 per capita in 1978. In 2008, its GDP was recorded at \$525 billion, accounting for 12 percent of the national total, which was \$4,421 billion and was \$68 billion more than Shandong Province, which stood second in the national league (www.stats.gov.cn). It not only surpassed Singapore, Hong Kong and Taiwan but some of the G20 member states such as Indonesia, Argentina and South Africa in 2008 (Figure 5.20) (www.stats.gov.cn and Guo, 2010).

Figure 5.20 Comparison of Guangdong's GDP with selected G20 countries as well as other provinces in China in 2008.



Source: www.stats.gov.cn and Guo, 2010

The booming of the economy soon turned the PRD region into the world's largest processing base for exports. In 2002, its exports valued at \$112.5 billion, accounting for 34.6 percent of the national total and the figure jumped to 404 \$billion in 2008.

5.6.2.2 The new GBIA

Guangzhou was one of the first cities in China to be linked by air. The rapid economic growth after 1978 did not bring the same level of growth to its air transport sector compared with other airports in the same region such as Shenzhen. Despite its strategic importance in the nation's economic growth, the airport had failed to grow to a considerable size before 2004. Surviving in the shadow of Hong Kong, the airport reacted passively to domestic traffic to maintain its status. From 1978 to 2003, the airport mainly developed its domestic network with a few international routes linking itself to several cities in Southeast Asia such as Ho Chi Minh City, Vientiane, Bangkok, Rangoon and Jakarta.

The situation was changed in 2004, when in August, the New GBIA opened which is located about 28 kilometres from the city centre at the cost of \$2.4 billion. Replacing the 72-year-old previous Baiyun airport, the new state-of-the-art facilities claimed to be the first to be designed with a purpose of being a regional hub servicing Southern China and connecting Southeast Asia. The phase-one project is able to accommodate 27 million passengers and one million tonnes of cargo. The completion of phase two due in 2010 will enable the airport to handle up to 80 million passengers and 2.5 million tonnes of cargo. As the base of China Southern, the airport hosts 42 airlines connecting 110 destinations. Traffic grew faster over the last couple of years, with 2009 seeing a historical 37 million passengers, ranking the airport as one of the world's top 30 largest airports.

Cargo operation has been important for the airport. Over the years, the cargo throughput has been growing rapidly. In the year 2000, Guangzhou was ranked 3rd in terms of cargo traffic, recording 492 thousand tonnes of freight, behind Beijing and Shanghai Hongqiao. In 2007, its cargo traffic grew moderately with 695 thousand tonnes of freight being handled. The economic downturn affected the airport's cargo traffic more than it did its passenger traffic. Cargo traffic dropped to 686 thousand tonnes in 2008, though growth was back on track with 955 thousand tonnes being recorded in 2009.

5.6.2.3 Competition with other airports in the region

In the PRD region, there are five important cities, namely Guangzhou, Shenzhen and Hong Kong lying to the east of the Pearl River, and Zhuhai and Macau to the west. Hong Kong is 174 kilometres south of Guangzhou with three hours' drive. Shenzhen is adjoining with Hong Kong with highway, railway and waterway available for ready access. Zhuhai is 120 kilometres south of Guangzhou and is to the west of Macau. Macau is 66 kilometres to the west of Hong Kong (Figure 5.21). Ferry, coach and railway services run regularly between the five cities.

Figure 5.21 Geographical location of the five cities in the PRD region.



Source: HHI, 2010

Being close to each other does not mean that there is no need for more than one airport. Ironically it ends up with each city having an airport striving for the same catchment area due to historical reasons and different jurisdiction systems. Table 5.12 summarises basic information of the five airports.

Table 5.12 Basic information of the five airports.

Airport	Guangzhou	Hong Kong	Macau	Shenzhen	Zhuhai
Terminals	1	2	1	2	1
Runways	2	2	1	1	1
Designed Capacity (million)	80 for pax, 2.5 for cargo	40 for pax, 3 for cargo	6 for pax	11 for pax	12 for pax
Operational hours	24	24	24	24	24
Expansion plan	Cargo facilities	Cargo facilities	Terminal and cargo facilities	Terminal 3 and second runway by 2011	No

Base airlines	1	1	1	4	0
Airlines serving the airport	51 passenger, 12 cargo	95 in total	16 passenger, 1 cargo	32 passenger, 2 cargo	7 passenger
Daily aircraft movement	N/A	800	111	500	N/A
Destinations	100	150	22	102	16
Passenger throughput in 2009 (million)	37	46.2	4.3	24.5	1.2
Cargo throughput in 2009 (thousand tonnes)	N/A	3,350	N/A	605	N/A
multimodal	Yes	Yes	Yes	Yes	Yes

Source: compiled by the author from the information available on the websites of the five airports.

The geographical proximity is reinforced by economic links since 1978. As a result of the divestment of manufacturing facilities to PRD region, Hong Kong has since remained the top trade partner of Guangdong, though economies such as the US, Japan, Taiwan, South Korea and Germany were also on the top ten league of Guangdong's trade partners. The close economic link also enabled Hong Kong to have developed into a biggest transit port to export China-made products with up to 80 percent of its freight coming from the PRD region.

Hong Kong's Chep Lap Kok airport became operational in July 1998 replacing the previous Kai Tak airport and has since remained one of the top ten busiest airports of the world. Hong Kong's designed capacity for passenger traffic is about 40 million, only half of that of Guangzhou despite cargo capacity being larger at three million tonnes. Currently Hong Kong is connected to 150 international cities served by 95 airlines. With Cathay as its home carrier, one of the best and strongest airlines of the world, Hong Kong Airport has been dominating the air transport sector of the PRD region over the last three decades. Air cargo has been one of the important services for Hong Kong Airport. Being ranked as one of the busiest airports for international air cargo since 1996, the airport handled 3.4 million tonnes of freight in 2009, accounting for 35.3 percent, or HK\$1,821 billion, of the total value of Hong Kong's external trade (www.hongkongairport.com), majority of which came from the PRD region.

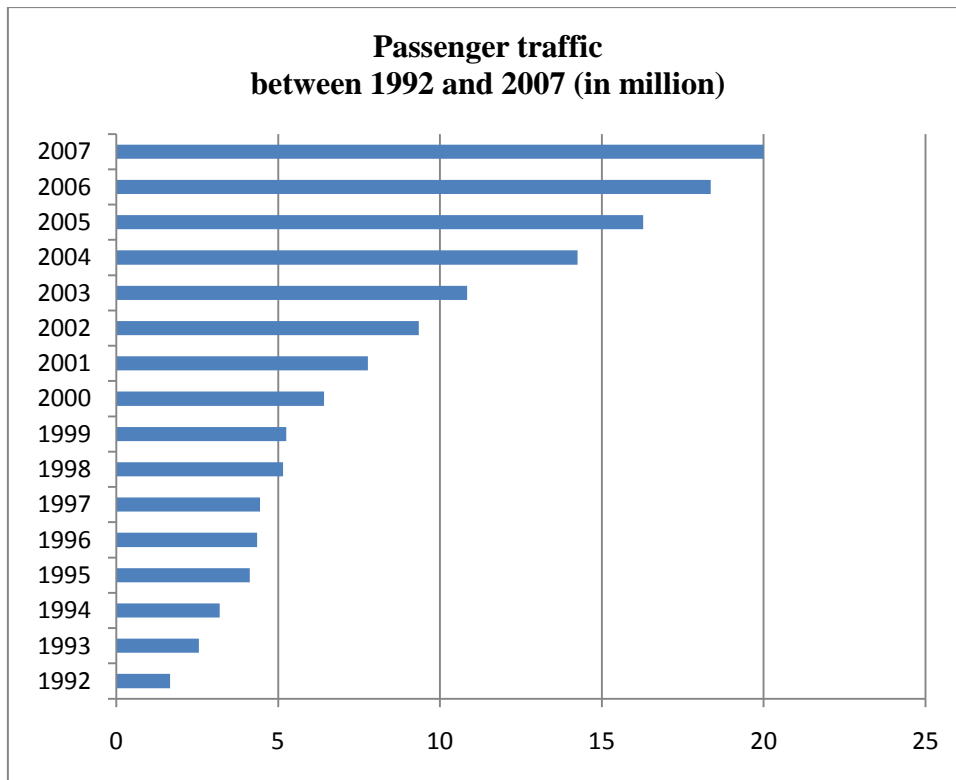
The transit arrangement caught the attention of Chinese airports in the 1990s when the US started to accept direct shipment of Chinese products rather than being transited via Hong Kong. Demand for cargo traffic soared at both Guangzhou and Shenzhen airports, both of which were ambitious in developing cargo operations. However, not much had been done until before the 21st century due to Hong Kong's market power, which overshadowed other airports in the region. Another reason was that external circumstances such as the Financial Crisis in Southeast Asia in 1997, 9/11 terrorist attack in 2001 and SARS in 2003 hit the economic growth of the region badly with demand for air transport being severely affected. A third justification was the restrictive air transport policies which hampered the growth of Guangzhou and Shenzhen, which were not the designated points of call for international carriers.

With all these constraints, none of the Chinese airports had had any plan to develop into a regional hub until 2004, when the costly new GBIA (\$2.4 billion) was opened for operation, which marked a new era for Chinese airports. Time was also just right for them to challenge Hong Kong: China had entered the WTO, airports had been transferred to local authorities for management and operation, some relaxed bilateral agreements had been concluded between China and foreign counterparts including the US, and a free-trade zone was also agreed with ASEAN member states.

Guangzhou began to compete. Branding itself as the south gateway to China as well as providing the easiest access to Southeast Asia through its home carrier China Southern's biggest domestic and regional network and that of Sky Team, the airport started to aggressively promote itself to the aviation community by signing strategic partnerships with freight forwarders and logistics companies. In addition, it set up a cargo station in Dongguan and opened offices in Zhuhai and Shenzhen with the aim of extending its cargo network to the whole region and beyond.

Guangzhou's move stimulated Shenzhen airport, which announced its expansion plan in 2005 for a second runway and third terminal for operation in 2011. Shenzhen was crowned as the cradle of China's economic reform launching the first SEZ of the country in 1978. The airport was constructed in two phases with a total investment of 1.9 billion Yuan (\$680 million). Opened for operation in October 1991, the airport soon became the fourth largest with a total traffic of 4.4 million in 1996. In 2003, passenger throughput reached more than 10 million, resulting in being ranked in the world's top 100 airports (www.szairport.com.cn). Over the years, the airport has enjoyed 19.6 percent growth year on year, with more than 20 million passengers passing through the airport in 2007 (Figure 5.22). It is the home for 4 carriers including Shenzhen Airlines, Jade Cargo International, China Southern's Shenzhen Branch, and Donghai Cargo.

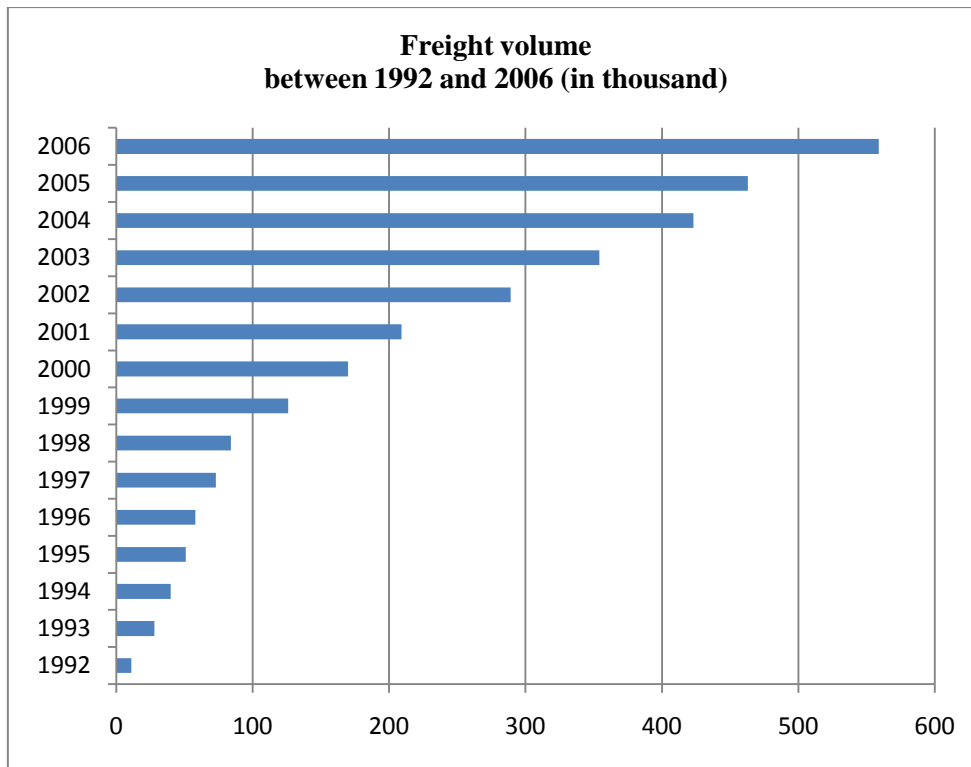
Figure 5.22 Passenger traffic between 1992 and 2007 at Shenzhen airport.



Source: www.szairport.com.cn

Cargo has always been its focus. Being the first Chinese airport to provide cargo transit transportation, the airport has benefited from its most convenient and highly efficient multimodal transport system by integrating air, highway, sea and waterway to provide seamless services to customers. Working closely with logistics partners, it has successfully transformed itself from a cargo agent into an all-rounded logistics service provider and increased its cargo volume dramatically. In 1992, the airport only received 11 thousand tonnes of cargo. The figure jumped to 560 thousand tonnes in 2006, an average of 36 per cent increase year on year with its international freight posting 83 percent growth (Figure 5.23). The \$10 million financial incentive offered by the local government in January 2007 further helped the airport to improve its facilities to attract more air services.

Figure 5.23 Freight volume between 1992 and 2006 at Shenzhen airport.



Source: www.szairport.com.cn

The continuous traffic demand and strong growth, state-of-the-art facilities, home carriers' support and the financial backup has enabled Shenzhen Airport to develop a stronger position to compete. In addition to its expansion project to be completed in 2011, it also set up a cargo terminal in Dongguan, where Guangzhou Airport also has a terminal opened in September 2009. To secure consignments, an arrangement has been agreed with the Dongguan local authority which has committed to offering financial incentives to those consigners who would ship via Shenzhen Airport (www.szairport.com.cn).

Hong Kong, observing all this development, immediately reacted to defend its leading position. Discounted charges were offered to carriers as an incentive to encourage more frequencies and new routes. Ten new cargo gates for cargo airliners were constructed which became operational in late 2007. In addition, it works closely with its base airlines with Cathay Pacific Cargo Terminal being constructed in September 2008 and due to be complete by the second half of 2011, with a designed capacity for annual air

cargo throughout 2.6 million tonnes. Being regarded as a groundbreaking initiative, the Terminal would allow Cathay to operate at the airport under a 20-year agreement, in which Cathay invested a total of approximately HK\$4.8 billion, occupying a site of around 10 hectares in the airport's cargo area (www.cathaypacificcargo.com). Cathay's investment is praised as being representative of its significant commitment to the reinforcement of Hong Kong's position as a leading regional and international aviation hub and a future vote of confidence in Hong Kong's future (www.cathaypacificcargo.com). The HKAA claimed that it was important to maintain the momentum of the infrastructure investment so that Hong Kong was fully prepared to achieve better growth in the longer term.

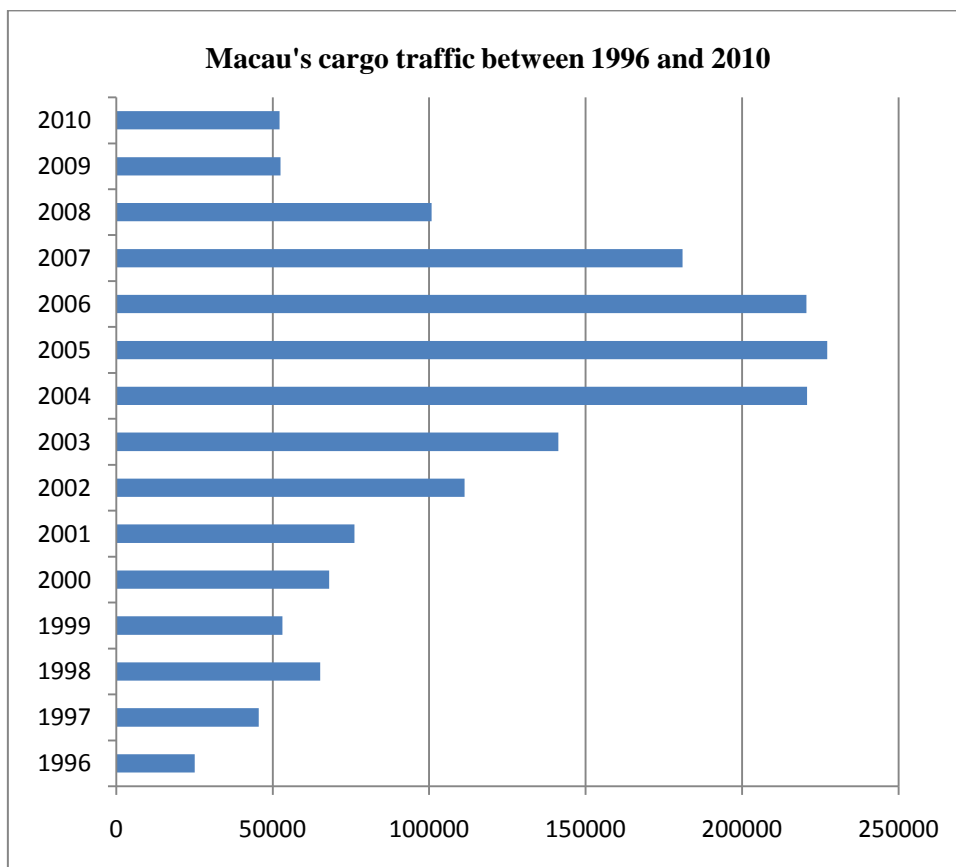
Besides, the Hong Kong Airport Authority (HKAA) has made various kinds of arrangements with some strategically selected airports in China to expand into the mainland Chinese market. For example, it is discussing possible collaboration on customs clearance of freight shipments with Shenzhen Airport and concluded a management contract with Zhuhai Airport in October 2006, both of which are within the same PRD region. The strategic arrangement with Zhuhai was regarded as a double-edge sword: on the one hand, it would refrain the growth of Zhuhai airport, while on the other hand, it would defend itself from Macau airport, which is just a few miles away from Zhuhai. In the YRD region, Hong Kong Airport acquired a 35 percent interest in December 2006 in Hangzhou Airport and reached an agreement with Shanghai Airport Authority (SAA) in October 2009 to establish a joint-ventured management company to manage the two terminals, east transportation centre and retail operations of Hongqiao Airport (www.hongkongairport.com).

Witnessing the aggressive movement in the region, Macau airport did not remain inactive. Commencing operation in November 1995, the airport was built with the primary purpose of serving as a transit point for passengers travelling between the mainland and Taiwan. Over the years, the airport has experienced rapid growth of both passenger and cargo traffic. In 1996, only 1.3 million passengers used the airport. The figure increased to 3.2 million in 2000 and jumped to 4.3 million in 2005 despite the launch of direct services between the mainland and Taiwan in January of that year. The strategic move to introduce low cost carriers (LCC) to the airport proved to be very

successful, which enabled the airport to maintain a robust growth. The airport became the first in the region to welcome LCCs such as Air Asia, Tiger Airways, Jetstar Asia, and Cebu Pacific and saw 5.5 million passenger throughputs in 2007. The financial crisis, however, hit the airport badly resulting in a sharp drop of passenger traffic with only 4.3 million being recorded in 2009 (www.macau-airport.com).

Macau is an entertainment centre without manufacturing industries. Air cargo mainly comes from the PRD region for transit to other destinations in the world, with the main destination being Taiwan which accounts for 72 percent of the total. Over the years, Macau's air cargo has benefited from the export-oriented economy of the PRD region and has been growing year on year until 2005 (Figure 5.24) (www.macau-airport.com). Recovery signs appeared in the first half of 2010 with 16,000 tonnes of freight recorded which represented a 59 percent increase.

Figure 5.24 Macau's cargo traffic between 1995 and 2010.



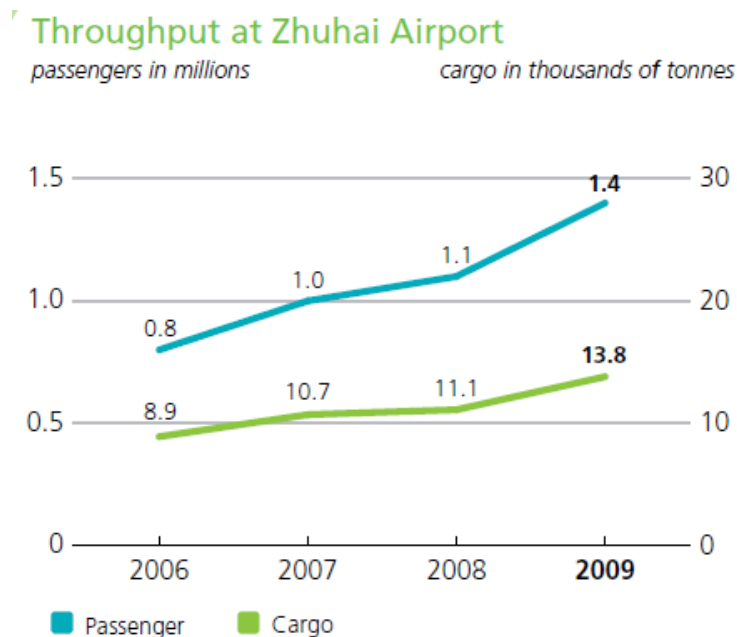
Source: www.macau-airport.com

With Air Macau as its home carrier, in which Air China has a stake, Macau is also planning airport expansion focusing on terminal and cargo facilities. Strategically, the airport brands itself as “the true airport in the city” and attempts to reinvent as an alternative gateway to mainland China. Recently it has introduced a variety of incentive schemes with the aim of attracting more airlines to fly to the city. Nevertheless, due to its limited capacity, shortage of manufacturing industries and aggressive promotion of other airports in the region, Macau’s prospect remains to be seen.

Contrary to the aggressive promotion and expansion of its neighbours, Zhuhai Airport has remained quiet. In reality, whether Zhuhai Airport should have been built used to be debated hotly and remained controversial until 2001, 6 years after its opening. This was provoked by the airport’s failure to repay its debt to an external creditor due to its meagre business since 1995 (Sinclair, 2001). The industry regulator CAAC did not agree the construction proposal but was overruled by the then Premier Li Peng. Opponents questioned its viability as it was so close to Hong Kong, Guangzhou, Shenzhen, and especially Macau, all of which are just at arm’s distance with rail, highways, and ferry services to connect Zhuhai. Yet, politics overtook the reasoning and the airport has since been struggling to survive.

The situation did not improve until 2005 when Spring Airlines (Spring) introduced a Shanghai-Zhuhai service. This is especially attractive to mainland Chinese who are enabled to take a day trip to Macau, the city that Spring was not allowed to operate due to regulatory restrictions in those days. Thanks to the services, Zhuhai airport’s traffic has grown from 0.8 million in 2006 to 1.4 million in 2009 and cargo volume increased from 8,900 tonnes in 2006 to 13,800 tones in 2009 too (Figure 5.25) (HKIAA Annual Report, 2010).

Figure 5.25 Zhuhai Airport traffic from 2006 to 2009.



Source: www.hongkongairport.com

Zhuhai is one of the first four SEZs set up in 1978. However, it failed to gain any momentum to grow into a major industrial city the same size as any of the other three, especially Shenzhen, although it boasts to host such industries as electronics and communications, instruments and pharmaceuticals. The Zhuhai Air Show is one of the few biggest events in the city attracting thousands of industry visitors and is the only time of the year when the airport gets busy. Facing the hottest competition between the airports in the region, Zhuhai does not seem to have taken much action, nor any plan or such intention has been released.

All in all, airports in the PRD region not only compete for route network coverage but also with their money-rich infrastructure, with all believing that investment in infrastructure playing a vital role in entailing airlines and their services. Hong Kong's advantages lie with its free trade system, international management experience and wide coverage of network but it is disadvantageous in terms of its high labour cost, higher service charge due to its strong currency values. It will make sense that Hong Kong is to become more involved with high added-value products which are time but not price sensitive, while at the same time strengthening its position as the main cargo transfer

airport. Shenzhen has the advantages of close proximity to manufacturing facilities though being restrained by limited capacity. Guangzhou's advantages lie in its expansion capability and state-of-the-art facilities though its limited international network hinders its competitiveness as a real hub, despite of its efforts in attracting more and more international carriers, which just recently launched services to the city including Lufthansa, Emirate, Kenya and Etihad.

Until today, Hong Kong's ability to remain as the leading gateway to China has been, to a great extent, attributable to the following justifications: the un-competitiveness of Chinese airlines and airports as well as Beijing's restrictive bilateral arrangements with its international counterparts, with agreements being traditionally on a quid pro quo basis, resulting in the Chinese airports to be largely closed to foreign carriers (Robinson, 2006).

The series of measures taken by CAAC since 2002 have been aimed at rationalizing the airline industry to enhance the competitiveness, optimising the resources, and improving the industry's profitability. Airports such as Guangzhou and Shenzhen posted a threat to Hong Kong's status as the hub. The grant of more traffic rights to foreign airlines to China, in particular Guangzhou, has caused Hong Kong airport to slip as the primary transportation gateway to China. Competition will remain fierce unless a coordinated development plan is to be in place to grow the airports in the region into an aviation bloc when viewed collectively and may eventually develop a unique consolidated role in the Asia-Pacific region (Goel, 2006).

5.6.2.4 Calling for collaboration

Over the last three decades, the PRD's role in China's economic growth has been pivotal (Leman, 2003). With the return of Hong Kong and Macau to PRC sovereignty as SARs, the region has assumed a bigger role in the economic growth of Greater China despite the problem for its sustainable growth being its low valued products, poor coordinated transport system, lack of management skills, and imbalanced distribution of resources.

A study conducted by Chreod Ltd in 2000 confirmed that there existed a concentrated megalopolis stretching from Hong Kong, Dongguan, Guangzhou, Foshan and Shunde to Jiangmen and likely to extend to Zhongshan, Zhuhai and Macau by 2020 (Leman, 2003). The importance of this megalopolitan zone is its ability to maintain the region to be a principal economic powerhouse of the country or region with a concentration of consumers, purchasing power and production that incubates new and higher forms of economic development and growth. To make the PRD a truly efficient and productive megalopolis akin to that of Tokyo and Osaka in Japan and Boston through New York to Washington in the US, one of the key issues to be addressed is the transportation and communication system which enables the effective flow of people and goods.

To ensure the region's sustainable long-term growth, the central, local and SAR governments have called for concerted efforts from all parties involved to forge a comprehensive transport system to support the economic growth of the region and to develop the region in a coordinated way to improve its competitiveness on a global scale. Plans for a giant bridge linking Hong Kong to mainland China and Macau, a US\$2 billion project, was hammered out in June 2003 and A Master Plan for the Reform and Development of the Pearl River Delta was released in December 2008 by the SC, which provided a roadmap to enable an effective multi-modal port system to be nurtured with each city having its unique role to play to be complementary to each other (The National Development and Reform Commission, 2008).

5.6.2.5 GBIA and its home carriers

5.6.2.5.1 China Southern Airlines

China Southern Airlines was formed in 1989 being licensed to operate on both domestic and international routes. Based in Guangzhou, the carrier has the advantage of serving the most industrialised area in China in both passenger and cargo markets. In the early years, its international routes were limited to destinations in East and Southeast Asian countries as a result of the restrictions on its AOC licence as well as the unavailability of aircraft. However, the consolidation in 2002 enabled the carrier to capture the vast domestic market with the most extensive network and soon became the most competitive airline of the country.

The takeover of Shenyang-based China Northern Airlines and Urumqi-based China Xinjiang Airlines allowed the carrier to expand its network to both northeast and northwest China. The long distances between Guangzhou and Shenyang, and Guangzhou and Urumqi, which are 3,080 and 4,760 kilometres respectively, enables the carrier to expand its network to cover most of the major cities across the country (Figure 5.26). In addition, the two cities serve as regional hubs allowing the carrier to develop regional routes and increase capacity to destinations in Russia and north and central Asia. As a consequence, China Southern has remained the biggest domestic carrier carrying more domestic passengers than the rest of the Chinese airlines since 2005. In 2007 the carrier became the first Chinese airline to transport more than 50 million passengers, which made it one of the world's top 10 airlines in terms of passengers flown. In 2009, the airline carried 66.3 million passengers, of which 54.2 million comprised domestic traffic, ranking it the fourth largest airline measured by domestic traffic, with operational revenues of \$8.0 billion (Figure 5.27). The growth in passenger numbers has gone hand-in-hand with a growth in passenger load factor which has climbed from just over 60 percent in 2000 to 65 percent in 2002, 70 percent in 2005, and 74.5 percent in 2009. Although the carrier made a loss in 2008 affected by the global financial crisis, its huge domestic market helped the carrier to turn into black with \$48.3 million profit in 2009 (Table 5.13) (www.csair.com.cn).

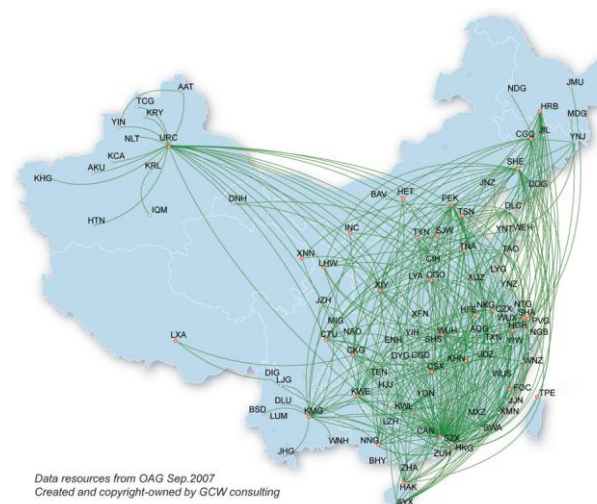
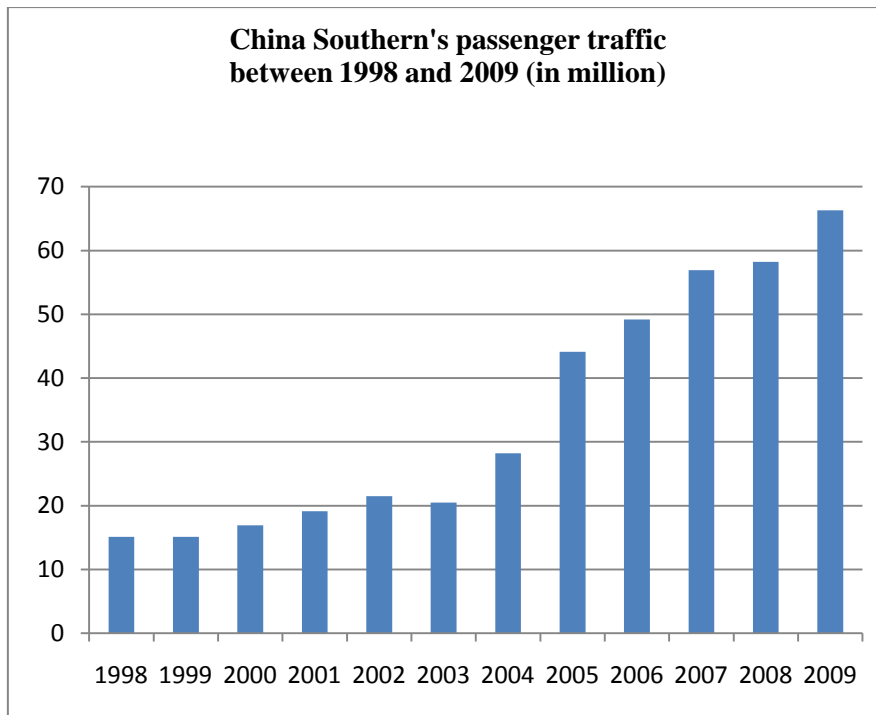


Figure 5.27 China Southern's passenger traffic between 1998 and 2009 (in million).



Source: www.czair.com.cn

Table 5.13 China Southern's operational and financial performance between 2005 and 2009.

	2005	2006	2007	2008	2009
Passenger load factor (%)	70.1	71.7	74	73.8	75.3
RPK (in million)	61,923	69,575	81,172	83,184	93,002
ASK (in million)	88,361	97,044	109,733	112,767	123,441
RTK (in million)	1,766	1,861	1,973	1,786	1,781
ATK (in million)	7,284	8,062	9,250	9,200	10,067
Passenger revenues (in million)	4,197.00	5,222.00	6,529.00	7,279.00	7,328.00
Cargo revenues (in million)	378	445	488	506	426
Other revenues (in million)	107	142	159	199	269
Total revenues (in million)	4,682	5,808	7,175	7,983	8,021

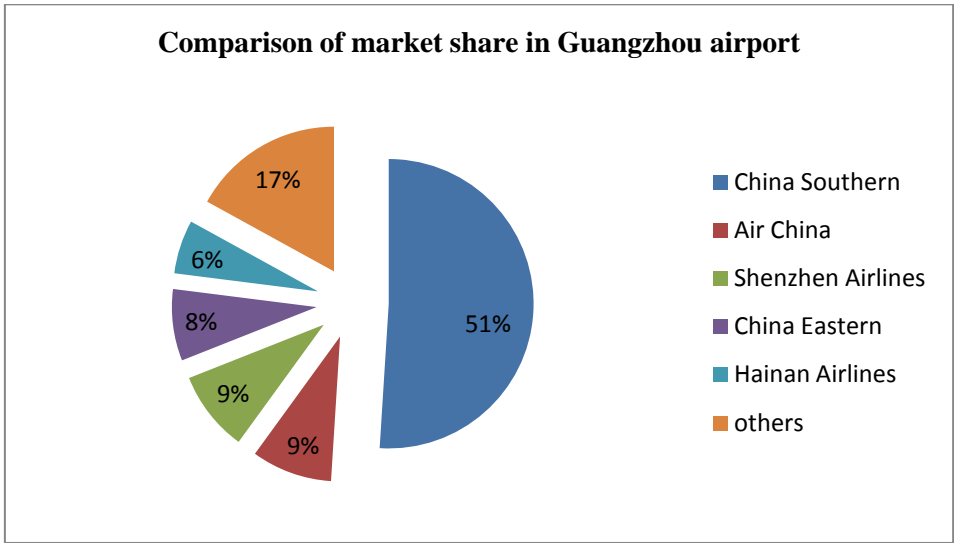
Operating result	-160	39	208	-815	211
Net result	-226	26	-243	-696	48

Source: www.rati.com

In the early days of the consolidation, the carrier seemed to be confused about its hub strategy as it invested heavily in Beijing airport, rather than Guangzhou, taking Terminal One for its exclusive use for both domestic and international operations with increased capacity to international long haul destinations in the US and Europe (www.czair.com). However, the strategy changed in 2004 when the central government decided that Guangzhou should be developed into one of the main three hubs (the other two were Beijing and Shanghai). At the same time, the opening of the new Guangzhou airport in August 2004 reinforced the carrier's confidence to grow from its home territory. Joining SkyTeam in November 2007 enabled the carrier to be clarified about its objectives: Guangzhou should be more leveraged in supporting its long-term vision to be the biggest and most competitive airline in China while at the same time keeping Beijing as its main hub.

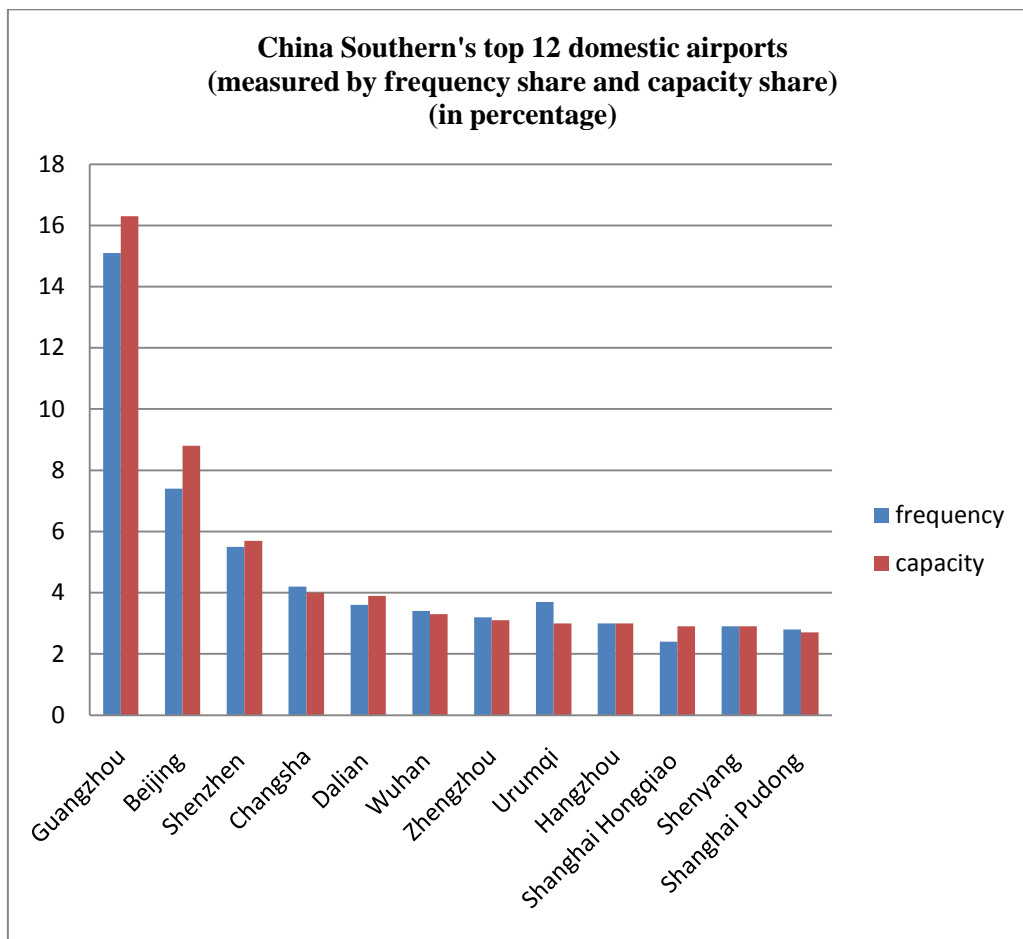
With a fleet of over 300 aircraft (a healthy balance between Airbus and Boeing models), the airline currently originates majority of its flights from Guangzhou servicing to 101 domestic airports and 51 international destinations with 51 percent market share, followed by Air China and Shenzhen Airlines with 9 percent (Figure 5.28). In addition to Guangzhou, the airline also operates from 10 other Chinese airports to Hong Kong and 12 airports to Seoul in South Korea, which accounts for 40 percent of its international capacity. Figure 5.29 shows China Southern's top 12 domestic airports served and its capacity and frequency share in the local market based on data from OAG in April 2008.

Figure 5.28 China Southern’s market share in Guangzhou airport measured by seat capacity for April 2008.



Source: www.centreforaviation.com

Figure 5.29 China Southern's top 12 domestic airports measured by frequency share and capacity share (April 2008).



Source: www.anna.aero

Compared with its dense domestic routes, the carrier is relatively weak in its international route network, with only two destinations served in Europe, i.e. Amsterdam (daily from Beijing) and Paris CDG (four times weekly from Guangzhou) and one in the US, i.e. Los Angeles (five times weekly from Guangzhou). Joining SkyTeam officially in November 2007 provided the carrier a better opportunity to offer international connections to its passengers. However, this does not mean that it would not have to compete with those international giants such as Lufthansa, Emirates and United Airlines which just entered Guangzhou market not long ago and are working to expand their operations.

Facing the aggressive moves of its domestic rivals, namely Air China's takeover of Shenzhen Airline and joint-ventured ACC with Cathay, as well as China Eastern's merger with Shanghai Airline in February 2009 and the announcement of joining SkyTeam in April 2010, China Southern seemed to have remained quiet in its reactions except for a claimed plan to join SkyTeam Cargo in November 2010. The carrier hopes that such a move will help to improve its cargo service and extend its network by having access to over 10,000 cargo flights every day to more than 130 countries provided by the SkyTeam Cargo Alliance partners¹¹ (www.skyteam.com), thus supporting its ambition to develop further its cargo operations in the PRD region where it competes with Cathay, Fedex, Jade Cargo and other carriers. China Southern's wholly owned subsidiary, China Southern Cargo, operates four Boeing 747 freighters as well as belly cargo services from SPIA to Amsterdam, Frankfurt and Chicago. Four more B777 freighters are expected to join its fleet by the end of 2011, which will enable the carrier to expand into Vienna, New York, Dallas and other international destinations across Europe and North America (www.skyteam.com).

5.6.2.5.2 Airline competition in the region

Renowned for accommodating the world's largest manufacturing facilities of all industries with statistics forecasting that by 2020 the air cargo volume in the PRD region could reach 20 million tonnes, there has never been short of competition for air cargo, which has taken a great proportion of all the international consignments. Apart from China Southern Cargo, twelve more all-cargo carriers also operate at Guangzhou, which include Lufthansa Cargo flying to Frankfurt, Korean Air Cargo serving Seoul and Sydney, UPS operating to Anchorage, Honolulu, Ontario, Seoul and Sydney, to just name a few. In addition, several international carriers have set up their Asian hubs in either Guangzhou or Shenzhen, which make the competition more intensive.

For example, FedEx, a designated carrier to the Chinese market by the US government, chose Guangzhou as its Asian integration hub to replace Subic Bay in July 2005 and became officially operational in February 2009. The hub takes an area of 63 hectares with a total floor space of 82,000 square meters with its own ramp control tower, which

¹¹ SkyTeam Cargo Alliance includes Aeromexico Cargo, Air France Cargo, Alitalia Cargo, Czech Airlines Cargo, Delta Cargo, KLM Cargo and Korean Air Cargo.

enables the carrier to control its aircraft movements on the ground. Also at the hub is a unique packaging and sorting system allowing up to 24,000 packages sorted per hour or 1,800 tonnes per day. The carrier currently operates to 30 destinations worldwide from Guangzhou, including Shanghai, Tokyo, Osaka, Seoul, Sydney, Paris, Frankfurt, Anchorage and Memphis. To strengthen its presence in Asia Pacific, 20 more new cargo centres will be opened shortly, with 12 being located in China.

Another showcase is UPS, which just opened its second hub in Shenzhen airport in May 2010, despite having a hub in Shanghai and operating regular services to Guangzhou. As the world's fourth largest all-cargo operator and also one of the designated carriers in the Sino-US market, the carrier is convinced, after learning that 37 percent of the profit increase in its international operations comes from the Asia-Pacific region, that Shenzhen airport would serve as a perfect hub to help distribute freight within Asia Pacific. Occupying an area of 89,000 square meters with the capability of sorting 18,000 pieces per hour (www.szairport.com), the hub enables the carrier to launch 78 weekly services to Cologne, Tokyo, Osaka, Incheon, Singapore, Kuala Lumpur, Bangkok, and Clarke, which has significantly enhanced its connectivity to Asia Pacific. This is complementary to its Shanghai-based service which is more aimed at serving Europe, the US, and the Middle East.

Others such as DHL and TNT have either completed its Hong Kong Central Asian hub expansion in 2008 or announced to upgrade its Hong Kong Hub in September 2009. TNT has also signed an agreement with Shenzhen airport to set up a special distribution centre at the airport.

Besides those international cargo giants, local carriers or joined-ventured enterprise joined the competition too. For example, Jade Cargo International, set up in August 2006 jointly by Shenzhen Airline (51 percent) and Lufthansa Cargo (25 percent) and a German investment bank, is also based in Shenzhen airport. As the first joint-ventured all-cargo carrier licenced by CAAC for international operations, the airline is able to take advantage of this manufacturing powerhouse for the supply of consignments for international shipment. Though a late comer, it has successfully launched services to Los Angeles in the US, Amsterdam, Paris, Frankfurt, Luxemburg, Stockholm and

Barcelona in Europe. Recently, it has launched a twice-weekly 747 freighter service from Shenzhen to Houston via Shanghai and Vancouver and plans to increase the capacity to three in the near future. New York and Chicago are also under the consideration.

Cathay Pacific, with years of operations based in Hong Kong airport, operates one of the world's biggest freighter fleets and has developed a worldwide network that enables the carrier to carry 1.3 million tonnes of freight annually through the airport (www.asiapacificaviation.aero). The strong recovery of cargo in the PRD region in the early 2010 stimulated the carrier to invest some HK\$20 billion in new freighters which will double its freight capacity within the next five years. The joint-ventured cargo airline with Air China based in Shanghai will ensure Cathay's focus of its efforts in strengthening its position in the PRD region, while at the same time ensuring its competitiveness in northern China and the YRD region. Together with Dragonair, its subsidiary founded in 1985 operating dedicated all cargo services to Asia Pacific, Cathay is able to maintain its status in the PRD and expand into mainland China. It currently operates 84 all cargo weekly flights, falling from 124 flights at its peak in 2008. In response to the recent strong growth, Cathay decided to launch a twice-weekly round-the-world service in early July 2010 with a B747-400 freighter, which flies from Hong Kong via Anchorage to Chicago and returns to its base over Amsterdam and Dubai. Also in early July the airline announced an increase in freighter frequencies to Houston and Miami to four and five flights per week respectively.

5.6.3 Airports in Shanghai and the YRD region

5.6.3.1 Shanghai and the YRD region

Shanghai is located on the western coast of the Pacific Ocean at the mouth of the Yangtze River, which is the central point along the southeast coastline of China. With a population of 18.9 million in 2008, about one percent of the national total, Shanghai has served as one of the major trading cities and the gateway to China for more than a century, contributing to one twelfth of the nation's total industrial output and one sixth of the country's total cargo volume.

Compared with Beijing and Guangzhou, Shanghai's advantage lies in its dynamic economic activities in the YRD region which includes provinces such as Jiangsu and Zhejiang with Shanghai as its centre (Figure 5. 30). It is the fastest growing economic zone in China with an annual growth rate of 9.5 percent and has emerged as a global export region since the early 1990s, generating \$201 billion worth of GDP in 2008. By 2008, Shanghai alone had attracted \$40 billion foreign direct investment from more than 80 countries and regions and traded with 210 countries and regions around the world, with a total trade value of \$3.2 billion. Being ambitious to develop the city into an International Shipping Centre as well as an international economic, finance and trade centre, the local government has injected a huge amount of capital to improve its infrastructure and the service since 1995 when the initiative was approved by the SC (www.infor.hktdc.com).

Figure 5.30 Shanghai and the YRD region.



Source: Miu (2005)

5.6.3.2 Hongqiao and Pudong Airports in Shanghai

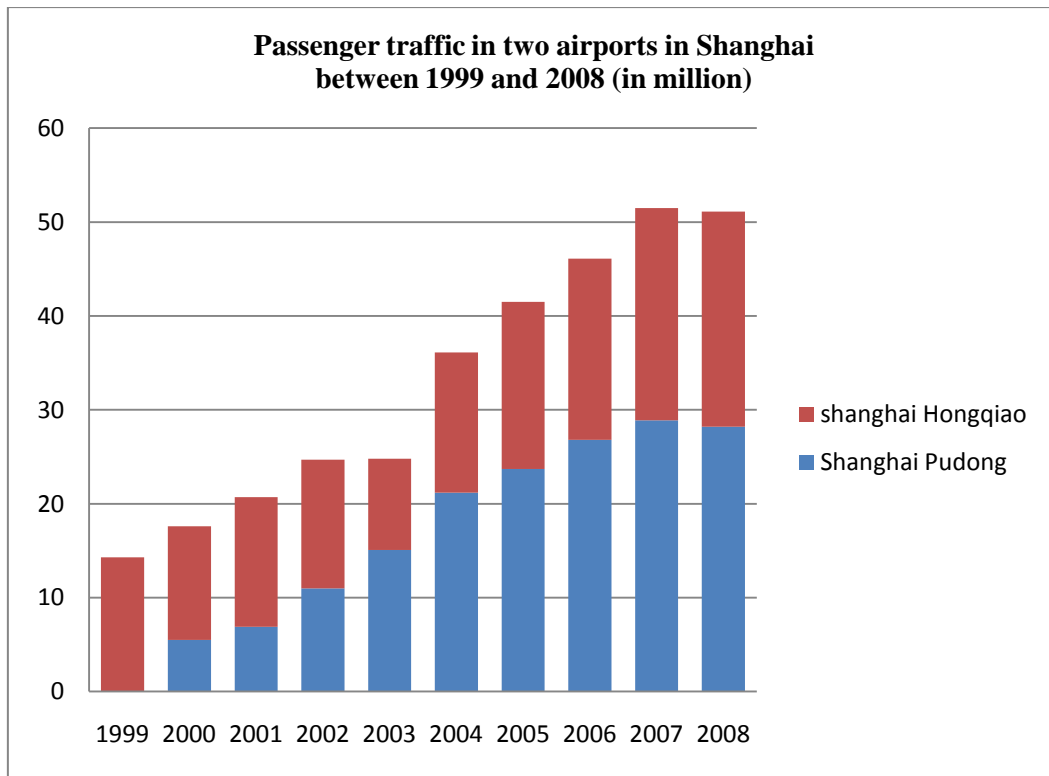
Before 2000, there was only one airport in Shanghai, i.e. Shanghai Hongqiao International Airport (Hongqiao). Built in 1921, the airport was 13 kilometres away from the city centre, which adversely constrained its prospective expansion to meet its increasing traffic demand. The second airport, Shanghai Pudong, was opened in

October 1999 dedicating to international operations as a result of the government's decision in April 2001 that Pudong becoming an international hub while Hongqiao focusing on domestic traffic.

The policy shift resulted in the stagnant traffic growth in Hongqiao for the following years, which had not been improved until 2005, when the privately-funded start-ups such as Spring Airlines (Spring) and Juneyao Airlines (Juneyao), which were licensed for exclusive domestic operations, chose to base their operations at Hongqiao. In addition, the Beijing-Shanghai shuttle flight services jointly launched by mega-carriers such as Air China, China Eastern and Shanghai Airlines that were scheduled at every half an hour attracted significant amount of business passengers to the airport, which contributed to its increased traffic volume. The rule of serving exclusively for domestic traffic was recently broken by Korean Air and ANA, which, after successful lobbying CAAC with an argument that its convenient location to downtown centre and simplified procedures would be a great attraction and advantage to their business travellers, connected Seoul's Gimpo and Tokyo Haneda to Hongqiao respectively.

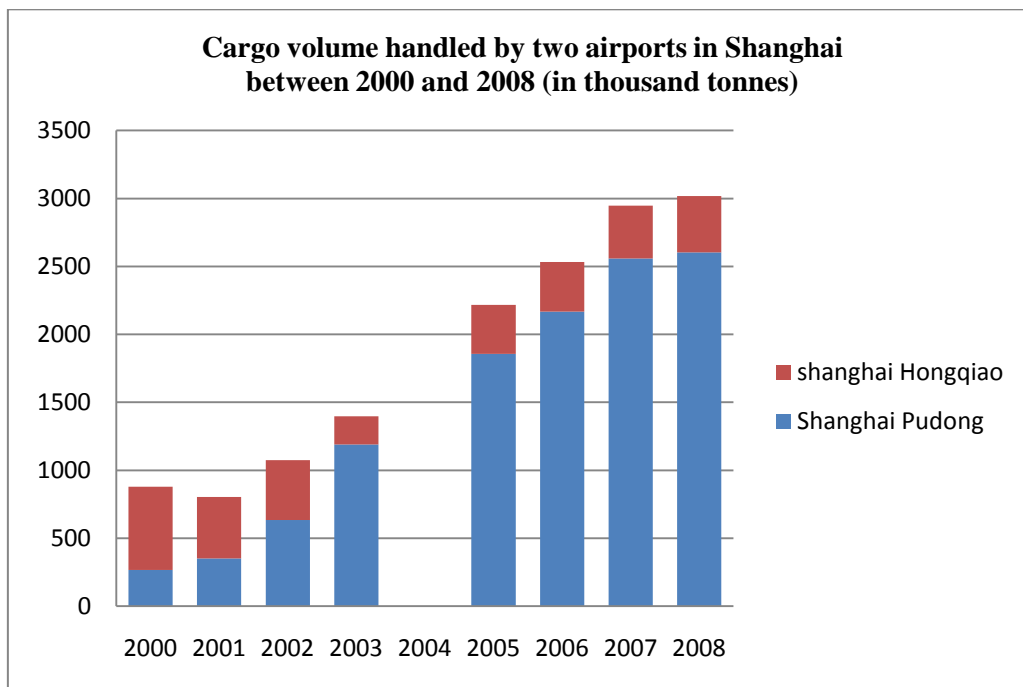
Shanghai is the only city in China that has two airports. When taking the traffic volume of the two together, despite some decline in 2003 and 2008, the two-airports system still allowed the traffic to treble from under 15 million in 1999 to over 50 million in 2007. Figure 5.31 and 5.32 show the traffic volume of both passengers and cargo since 1999.

Figure 5.31 Passenger traffic at two Shanghai airports from 1999 to 2008.



Source: Various issues of CAAC Statistics Yearbook and www.caac.gov.cn

Figure 5.32 Cargo volume handled at the two Shanghai airports between 2000 and 2008.



Source: Various issues of CAAC Statistics Yearbook and www.caac.gov.cn

With a clear positioning strategy in the market, Pudong has been successful in attracting international traffic since its opening. In only two years time, passenger traffic grew 2.7 times from 5.5 million in 2000 to 15.06 million in 2003, overtaking Shenzhen, Hongqiao and Guangzhou, ranking the second in the national league. However, it dropped to third place in 2007 due to its facility constraints.

To ensure its long-term sustainable growth, a second phase construction of Pudong was kicked off in December 2005, which included a second 480,000-square-metre terminal, a third runway, 38 parking positions designed for all freighter aircraft and a cargo and logistics park at the western edge of the airport (Pan et al, 2005). Investing \$2.5 billion and completed in 2007, the airport was able to handle 50 million passengers and 2.5 million tonnes of cargo a year. Furthermore, a blueprint has also been mapped out: by 2015, the airport will have 5 runways and 3 terminals, being able to handle 60 million passengers and 4.2 million tonnes of freight.

The region's sustainable economic boom has triggered a strong demand for air cargo, making the city the most favourable choice for all-cargo operators. The facilities at Pudong is particularly attractive for international consolidators such as UPS and DHL, which set up their regional hubs in 2005 and 2007 respectively, making Pudong the only airport in the world that boasts two global hubs which would substantially enhance its freight capacity. In 2009, the airport accommodated 74 airlines connecting 183 cities around the world and was the base for more than half of the all-cargo Chinese carriers including ACC, CCA, Shanghai International Cargo Airlines, Great Wall Airlines and Yangtze River Express. In terms of passenger services, domestic flights took only 44.7 percent of the market with the rest being international. Of all the international carriers operating in Shanghai, capacity to Hong Kong takes 12.3 percent, followed by that to Japan with 11.5 percent and South Korea with 6.5 percent. The US ranks fifth in the league and is the leading non-Asian market with 3 percent of all seat capacity, followed by European carriers with around 2 percent (www.centreforavation.com).

5.6.3.3 Shanghai and its home carriers

Taking an ideal geographical location with a sustainable economic growth, Shanghai has appealed to both domestic and international carriers, big or small, passenger and cargo. The dominance of China Eastern and Shanghai Airline was dismantled with the new entries and market structure changed.

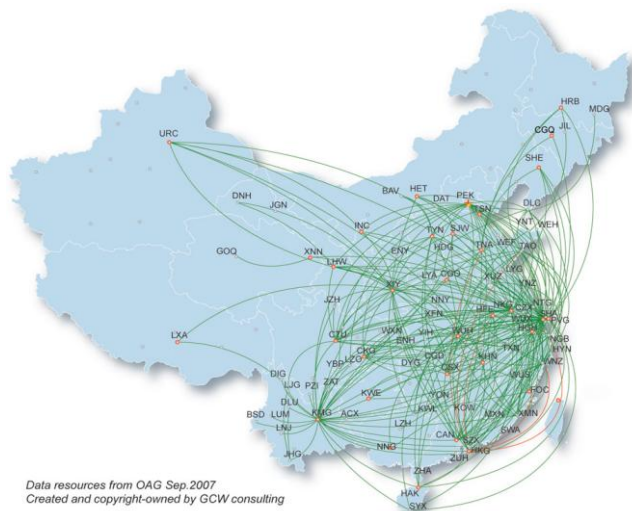
5.6.3.3.1 Shanghai Airlines

Shanghai Airlines (including Shanghai Airlines Cargo International) was set up in 1985 by the Shanghai Municipal Government (75 percent stake) as one of China's first independently-run commercial airlines. Though a non-CAAC controlled carrier based in Shanghai, it had been very successful in its early years operating many domestic trunk routes such as Shanghai-Beijing and Shanghai-Guangzhou. The carrier had not obtained its international route licence until September 1997 when it launched services to Thailand, Singapore, Hong Kong and Macau (www.shairlines.com); while a cargo service was only added to its portfolio in May 2004, focusing on long haul international routes such as Los Angeles in the US. It quit Star Alliance in October 2010, which it had joined in December 2007, after being taken over by China Eastern in July 2009.

5.6.3.3.2 China Eastern Airlines

When China Eastern was formed in 1988 as a result of the first round of administrative reform in the air transport industry with its base in Hongqiao Airport but then in Pudong Airport in 2000, it was authorised to operate on both domestic and international routes, with its international reach in the early years being limited to a few neighbouring countries in East Asia such as Japan and South Korea. Its long haul routes only included such countries as the US and Germany with which China agreed a double designation in terms of market entry. For example, the carrier operated on the Beijing-Shanghai-Seattle-Chicago route in the early 1990s and on Shanghai-Frankfurt in the middle of the 1990s. The consolidation in 2002 allowed the carrier to take over Kunming-based Yunnan Airlines in the southwest and Xi'an-based China Northwest Airlines in the central area. Figure 5.33 shows the carrier's domestic route network.

Figure 5.33 China Eastern Airlines domestic route network.

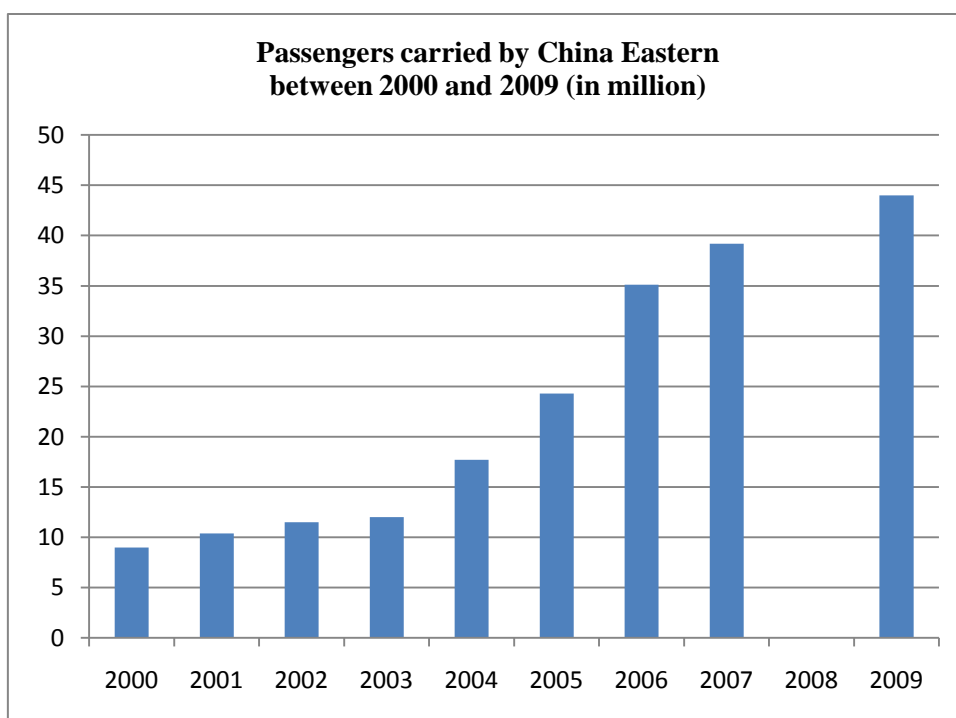


Source: GCW consulting (2007)

The acquisition did not help the airline to strengthen its hub in Shanghai, nor did it help create any synergy for business expansion or reinforce its presence across the country. On the contrary, the carrier took over a large amount of debt onto its balance sheet, causing financial losses in the following years except in 2007 and 2009. The route network of Kunming Airline helped it to maintain its market position in southwest China to compete with Air China whose regional hub is in Chengdu, which is 990

kilometres away from Kunming. China Northwest, however, though being at the very centre of the country in geographical terms, did not bring much value to its network development. The main reasons are that first, Xi'an is in the central-western region of the country which is relatively backward in terms of economic development, and second, it is not along the belt of the main traffic flows within China. Figure 5.34 and Table 5.14 reveal the carriers operational and financial performance from 2000 to 2009 and 2005 to 2009 respectively.

Figure 5.34 Passengers carried by China Eastern between 2000 and 2009.



Source: www.ceair.com.cn

Table 5.14 Financial performance of China Eastern between 2005 and 2009.

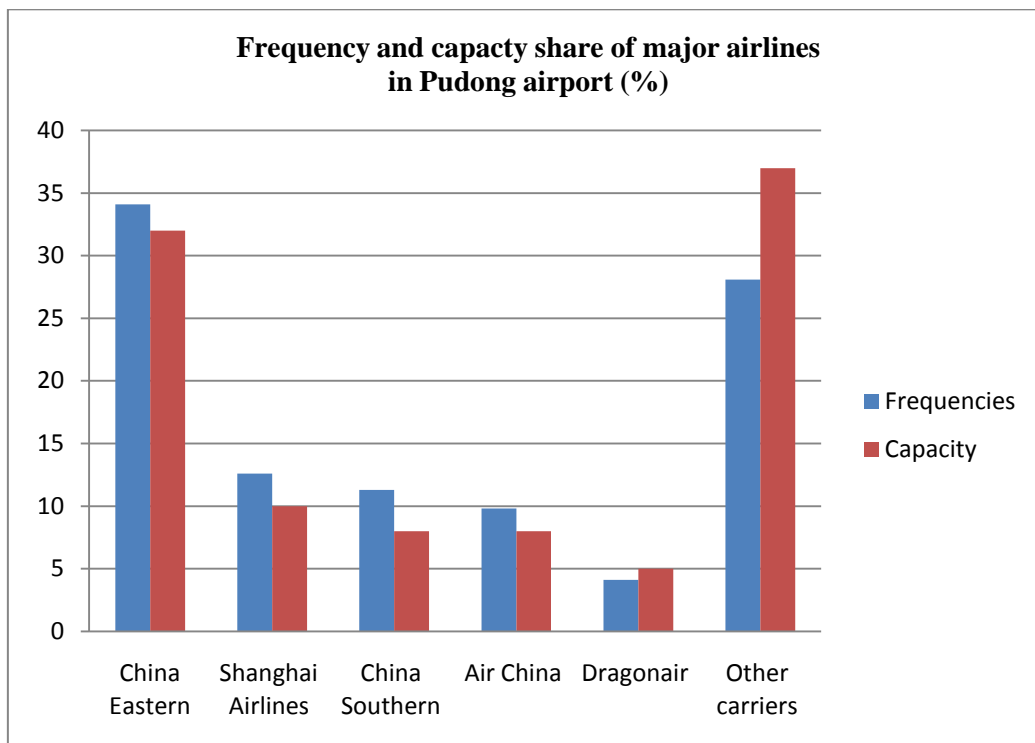
China Eastern's financial performance (in million US Dollar)					
	2005	2006	2007	2008	2009
Passenger revenue	2550	3825	4758	4835	4801
Cargo revenue	607	706	743	774	604
Other revenue	200	197	173	419	491

Operating result	-16	-376	17	-2178	25
Net result	-57	-434	50	-2205	25

Source: www.rati.com

Over the years, China Eastern has never ceased its efforts to achieve a turnaround by attempting to introduce strategic partners, though none of them had been successful. The first effort involved the sale of its 25 percent stake in CCA, a joint venture with the China Ocean Shipping Company, to Taiwan's China Airlines, which came to nothing. The second endeavour was to try to sell 24 percent of its shares to Temasek Holdings and Singapore Airlines in 2007, which was bitterly rejected by Air China that only has a 6 percent stake in China Eastern. Frustrated by its unsuccessful strategic alliances with investors, the airline announced in early 2008 that it would continue to seek strategic partners and would request the government's support where necessary. Eventually a takeover of Shanghai Airlines based in the same city was instigated in July 2009 with central government's approval. The used-to-be competitor became a wholly-owned subsidiary in January 2010, though retaining its own brand and independent operation. Analysis based on the scheduled seat capacity available for April 2010 revealed that the carrier still failed to dominate the Pudong airport, as China Southern did in Guangzhou, with a total market share being 43 percent, despite no other airline having more than a 10 percent of the capacity (Figure 5.35). Domestically, it has to compete with carriers such as Air China's Shanghai subsidiary as well as those Shanghai-based new start-ups such as Spring Airlines and Juneyao Airlines, which adopt a LCC business model and have demonstrated strong profitability over the last few years (www.caac.gov.cn). Internationally, the carrier has to fight with megacarriers such as United Airlines, Virgin Atlantic and Lufthansa, all of which have operations to Shanghai. With a fleet of 330 aircraft, the airline flies to 151 destinations, over 50 of which being international destinations including 14 in Japan and 5 in Korea (www.centreforaviation.com). After pondering for so many years without a clear vision and strategy, the airline seemed to have woken up from its tremendous loss in 2008 (\$2.2 billion). The successful acquisition of Shanghai Airlines boosted its confidence and its capabilities in terms of business expansion with the announcement of its intention to join SkyTeam in late April 2010, of which China Southern has been a member since 2007.

**Figure 5.35 Frequency and capacity share of major airlines in Pudong airport
(based on OAG data in April 2010).**



Source: OAG

5.6.3.3.3 China Cargo Airlines

CCA is the first Chinese carrier specialising in all-cargo operations. Being jointly established by China Eastern (holding 70 percent of the shares) and China Ocean Shipping Group Company (COSCO) in August 1998 in Shanghai, the carrier initially used the traffic rights of China Eastern to operate to US destinations including Los Angeles, Chicago, Dallas/Forth Worth, New York and San Francisco. It soon became an independent carrier being designated by CAAC to expand into Frankfurt, Amsterdam and Paris. The carrier plans to expand its fleet to 25 aircraft from the current 11 so that more frequencies and new destinations can be added to its network.

5.6.3.4 Competition at Shanghai

Although air cargo carriers acknowledge the current overcapacity in Asian market, there's still plenty of activity and expectation for the future. Together with the PRD

region the YRD region are considered two of the world's largest export-generating manufacturing centres and the airfreight trade lanes to Europe and the US reflect this fact in their size and historic growth rates. Competition in Shanghai is getting fiercer than anywhere else in Asia Pacific due to the rapid increase in cargo volume handled by all modes, which was recorded 590 million tonnes in 2009, making Shanghai the world's busiest multi-modal cargo port. In terms of air cargo, Shanghai accounted for 35 percent of the national total, of which, international cargo takes two thirds.

International carriers such as UPS and DHL have taken aggressive actions fighting in Shanghai's cargo market. The new hub of UPS in Shanghai opened in late 2008 takes an area of one million square feet at the southern end of the West Cargo Terminal Area at Pudong International Airport and is able to handle 17,000 pieces per hour. Working together with Yangtze River Express with domestic coverage, UPS is able to extend its reach extensively across China. The newly ordered 27 Boeing 767-300 extended range freighters to be delivered between 2009 and 2012 will enable the carrier to operate on routes from Shanghai to Asia, Europe and Latin America.

Yangtze River Express is the cargo unit of Hainan Airlines, with 49 percent investment from three Taiwanese companies including China Airlines. In partnership with UPS, the carrier serves Los Angeles, Anchorage and Boston with B737 and B747-400F freighters. Recently the carrier expanded to Stansted, its first European destination, and is looking for new potential markets.

The joint-ventured ACC relocates its operation base from Beijing to Shanghai with a firm belief that the city has more potential for cargo growth, where it must build a strong presence. Such a move will enable the carrier to better compete with its rivals including China Eastern, Great Wall, Yangtze River Express, FedEx, UPS and DHL. In the Shanghai market, ACC currently provides a 12.3 percent of freight capacity from China, followed by China Cargo Airlines with 11.7 percent. Great Wall Airlines has 5.4 percent of the freight capacity share followed by Cathay Pacific with 5.4 percent market share.

Taking Shanghai as its home territory, China Eastern is investing heavily with an aim of protecting its home. Recently, it acquired a 51 percent stake from Beijing Aerospace

Satellite Applications Corporation in Great Wall Airlines and became its biggest shareholder, with the other two being Singapore Airlines Cargo and Dahila Investment, a wholly owned subsidiary of Temasek Holdings. With its B747-400F fleet, Great Wall Airlines operates three weekly services to Atlanta via Anchorage and Chicago in the US, and once weekly to Manchester and 6 weekly to Amsterdam.

5.6.4 Summary

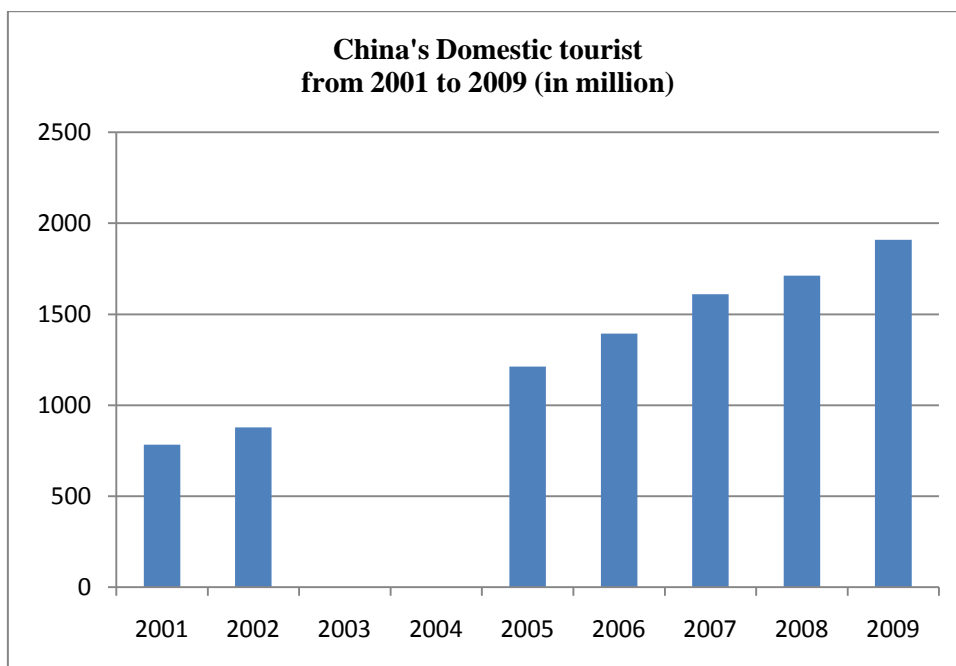
China's air freight, both domestic and international, has been growing remarkably since 1991, when only 452,000 tonnes was carried. The figure jumped to 4.45 million tonnes in 2009, representing an average 9.9 percent increase year on year (www.caac.gov.cn). Both PRD and YRD are the most dynamic regions in China with strong economic growth. In 2007, the two together generated more international trade than any other areas in China, representing 30 and 38 percent respectively of the national total (www.asiapacificaviation.aero). Unlike in Europe and America, where air freight has had to face highly efficient competition from containerised road operations and even on cross-water routes (OECD, 1997), air cargo in China has enjoyed its privileged advantage with less competition due to its inefficient operations of rail and road transport system. It will remain to be one of the main business areas that both airports and airlines will focus on and compete with all their efforts. The Master Plan for the development of the YRD region issued by the SC in May 2010 painted the roadmap for the future development of the region including Shanghai, Jiangsu and Zhejiang Provinces. Recognising that the region has become China's strongest area in terms of comprehensive competitiveness and the important power to lead the rapid and healthy growth of the national economy, the SC understands that the region comes to a critical stage of transition and that efforts are required to enhance its overall competitiveness and sustainability. The Plan positions Shanghai as the key gateway and centre of the international economy, finance, trade and shipping for Asia Pacific, with finance and transportation being the core industries to be developed (State Council, 2010). As the carriers from both sides of the Taiwan Strait have been allowed direct services, with Taiwanese carriers soon being allowed to operate cargo services out of China to US destinations (www.asiapacificaviation.aero), competition will be further intensified and all airlines are set to be involved in the fight for a piece of that traffic. But who will

become the strongest home carrier in both passenger and cargo services will remain to be seen.

5.7 Domestic or International?

China's strong economic growth has stimulated its domestic traffic, which has been growing faster than the international traffic. This is partly due to its vast landscape and the market size inhabited by a population of more than 1.3 billion people with around 610 million residing in the urban areas, which makes air transport the preferred choice for long-distance trips. Statistics from China's National Tourism Administration (CNTA) showed that there were only about 784 million domestic tourists in 2001, which jumped to 19 billion in 2009. Figure 5.36 shows the changes in the country's domestic tourist market since 2001.

Figure 5.36 China's domestic tourists from 2001 to 2009 (in million).



Source: www.cnta.gov.cn

In line with the country's economic growth, the majority of air travel is focused along the east coastline between Beijing in the north and cities in the south such as Shanghai, Guangzhou, Shenzhen, Hangzhou, Haikou, Chengdu and Kunming, which is a

reflection of the most dynamic economic activities in the region. In 2003, there were 8 Origin and destination (O&D) markets which attracted more than one million passengers, with the Beijing-Shanghai city-pair attracting 2.84 million. Among them, three originated from Guangzhou, with only one route departing from Beijing (Table 5.15). In 2007, 35 routes carried more than one million passengers with Beijing-Shanghai remaining on top of the league, attracting 5.8 million passengers. Of the top ten busiest routes, Beijing replaced Guangzhou by having seven routes originating from the city, while Guangzhou was left with two (Table 5.16). The traffic pattern to a great extent reflects a resemblance with that in the US domestic market, where traffic moves between north and south on the east coast (Williams, 1994).

Table 5.15 The top 8 domestic O&D city-pair markets in 2003.

Rank	Cit-pair	Passenger traffic (in million)	Total No. of flights	Cargo volume (in thousand tonnes)	Average load factor
1	Beijing-Shanghai	2.84	22,347	132.5	49.3
2	Shanghai-Shenzhen	1.79	14,832	101.1	66.9
3	Guangzhou-Beijing	1.52	10,709	69.7	62.3
4	Guangzhou-Shanghai	1.28	12,209	90.5	64.3
5	Beijing-Shenzhen	1.27	9,451	44.4	65.5
6	Haikou-Shenzhen	1.18	10,428	8.6	67.6
7	Chengdu-Beijing	1.11	9,910	28.6	66.6
8	Guangzhou-Haikou	1.0	8,832	8.8	65.4

Source: CAAC, 2004

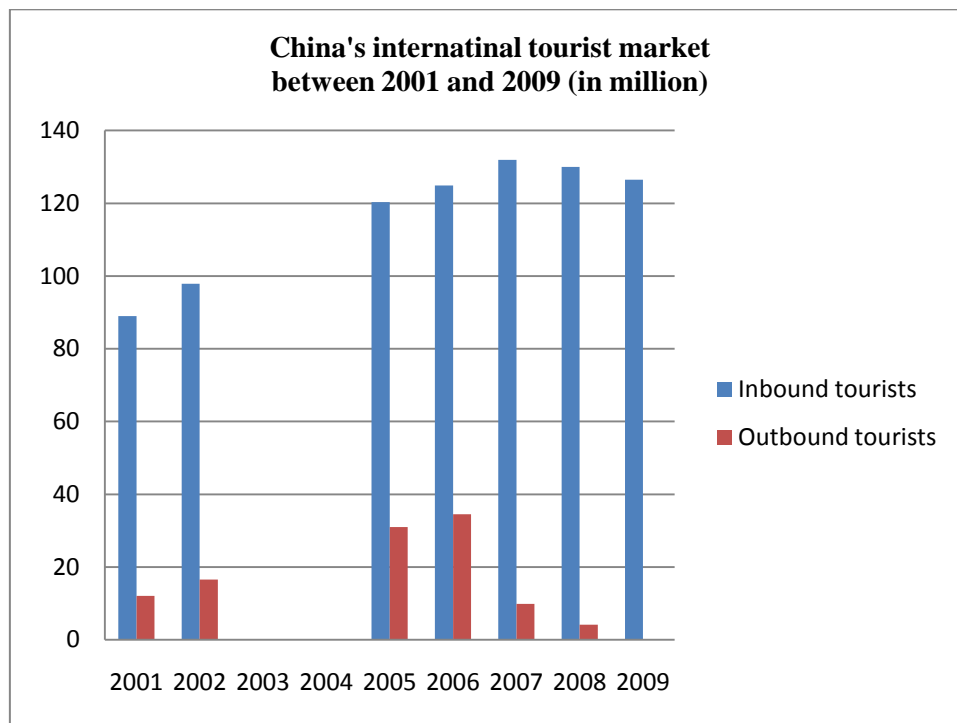
Table 5.16 The top 10 domestic O&D city-pair markets in 2007.

Ran k	City-pair	Passenger traffic (in million)	Total No. of flights	Cargo volume (in thousand tonnes)	Average load factor
1	Beijing-Shanghai	5.79	34,190	267.9	59.5
2	Shanghai-Shenzhen	2.83	20,860	125.2	74.9
3	Beijing-Guangzhou	2.7	14,352	94.2	71.9
4	Guangzhou-Shanghai	2.45	18,823	79.6	72.3
5	Beijing-Chengdu	2.28	15,769	52.5	71.2
6	Beijing-Shenzhen	2.19	12,779	82.4	79
7	Guangzhou-Hangzhou	1.75	13,678	33.1	79.6
8	Beijing-Xi'an	1.63	11,699	15.3	69.9
9	Beijing-Hangzhou	1.52	11,943	27.8	74.9
10	Beijing-Kunming	1.52	9,413	47.6	81.3

Source: CAAC, 2008

Compared with domestic market, China's international travel market has not grown at the same rate. Although international arrivals and Chinese outbound tourists have been increasing steadily over the years, the total numbers are still far less compared with the domestic traffic. In particular, the number of international tourists dropped sharply in the years 2008 and 2009 due to the economic downturn, although this did not affect China's domestic market. Figure 5.37 shows the changes in numbers of international tourists between 2001 and 2009.

Figure 5.37 China's international tourist market between 2001 and 2009 (in million).



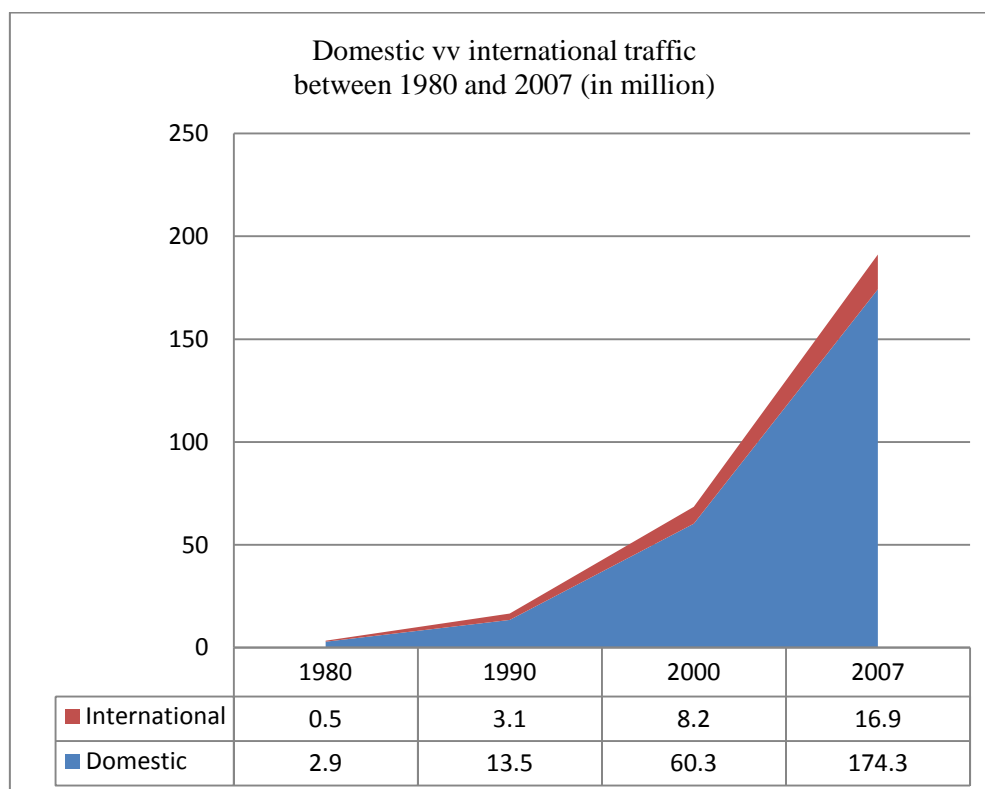
Source: www.cnta.gov.cn

To respond to the boom in domestic air transport market, Chinese airlines have deployed more capacity in domestic market rather than in the international ones. According to CAAC, 81 percent of the total fleet of 2,600 aeroplanes are single-aisles, mainly focusing on domestic operations. “Some airlines regard wide-body aircraft as a burden hence put too much capacity into the booming domestic market in their search for profit. As a result, the share of Chinese airlines’ in the international passenger market is shrinking, from 45.3 percent in 2005 to 44 percent in 2010. Even when they do allocate the remained capacity to international markets, they tend to focus on a few lucrative routes to Japan, South Korea and Southeast Asia where demand has remained at a high level. This, to a great extent, has undercut the strength of the country’s air transport industry as a whole”, as CAAC’s Administrator Li rightly observed (Li, 2011).

The rapid growth in domestic traffic can be explained as the consequence of the rapid economic growth within China, while on the other hand, it can also be argued that the restrictions of traffic rights arrangements between China and other countries has

discouraged and suppressed the demand for international travel. In 1980, of the total 3.4 million passengers carried, only 500,000 were international passengers, accounting for 15 percent of the total. By the year 2007, when a total of 191 million passengers were carried, only 16.9 million were international, accounting for 9 percent of the total, a 6 percent decrease compared with that in 1980 (Figure 5.38).

Figure 5.38 Domestic v.v. international traffic between 1980 and 2007.



(Remark: international traffic in the years 1980, 1990 and 2000 included Hong Kong and Macau, while in the year 2007, domestic traffic included Hong Kong and Macau).

Source: www.caac.gov.cn

As international trade between China and the rest of the world increases, the country's international air transport is set to rise. Bilateral arrangements with restrictions on the provision of air services have apparently become obsolete, requiring an urgent need to review the country's international air transport policy so as to make sure that its air transport industry is not constrained for further development. On the other hand, effective mechanism should be in place to encourage Chinese airlines to explore

international operations. Although a total of 112 bilateral agreements had been signed between China and its foreign counterparts by the end of 2010, only 54 countries and regions have been established schedule links by Chinese carriers (Li, 2011). An analysis of China's international air transport policy is essential to help the country have clarity about where the policy is now and how it has evolved, and hopefully to provide insight for the authority to act and react to the dynamic international environment.

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Chapter 6 China's international air transport policy on China-US market

6.1 The US' international air transport industry

Its vast size and robust commercial environment has kept high the passion for air travel in America, which boasts the world's largest single air transport market, with around two million people, 50,000 tons of cargo and more than one million bags travelling onboard 25,000 flights every day to destinations near and far (ATA, 2010). According to the DoT, around 338 million inbound and outbound trips were made between the US and other countries in 2004 compared to 315 million trips in 1990, representing an almost 7 percent increase (DoT, 2006).

As one of the most vital industries that kept the US producing and moving (ATA, 2010), air transport helped generate more than \$1.2 trillion economic activities and almost 1.1 million jobs in the US in 2009 and contributed to \$701.3 billion in trade value by shipping the highest value exports at \$117.77 dollars per kilogram compared with \$0.81 dollars per kilogram of sea transport. In 2008, the US airlines carried about 4.4 million tons of international air cargo, accounting for 18 percent of the 25 million tons transported globally in international service. Its international traffic generated 33 billion RTK, accounting for 25 percent of about 131 billion RTK of the global international air cargo traffic (DoT, 2009). In 2009, the industry recorded 769.5 billion revenue passenger miles (RPM) and 25 billion revenue ton miles (RTM) with 703.9 million passengers enplaned (ATA, 2010).

Developing out of the legacy of the two world wars, US airlines have remained to be a most competitive business. Through mergers and alliances, they have dominated the various leagues of the world top businesses. Of the Fortune 500 world businesses in 2010, 8 were US carriers, with United Parcel Services (UPS) taking 43rd place and FedEx 60th (www.money.cnn.com). Of the world top 10 airlines in 2009 measured by operating revenue, 5 were US carriers including Delta Airlines (DL) (hereinafter referred to as Delta), FedEx, American Airlines, United Airlines, and Continental Airlines (CO), (hereinafter referred to as Continental, part of United since 2010). When measured by passenger numbers, 5 out of the top 10 airlines were also US carriers with Delta taking the lead reporting 161 million passengers. If measured by operating fleet, 8

out of the top 10 airlines in 2009 were US carriers including Delta, American, Southwest, United, US Airways, FedEx, Continental, and SkyWest, with the industry fleet totalling 7,132, almost 7-fold more than that of all Chinese carriers (ATA, 2010).

As the cradle of the modern aviation industry, the US has been leading the way of global air transport development. The US airlines are recognized for their innovation in terms of strategic management and marketing initiatives. It is the first to develop the LCC business model after the industry's deregulation in 1978 which revolutionized the way people perceive air travel. It is the first to design a hub-and-spoke system to enable the legacy carriers to optimize their resources to achieve economies of scale. It is the first to develop a Frequent Flyers Programme (FFP) to retain the loyalty of passengers to secure traffic and the first to create the most powerful Computer Reservation Systems (CRS) for airlines to monitor their seat booking to optimize their yield and revenue. It is also the first to formulate codeshare arrangements and alliances to bypass regulatory constraints and circumvent the restrictions of foreign investment in national airlines in order to achieve international expansion.

Though initially resisting deregulation in the late 1970s and early 1980s, the industry has survived the turmoil and since enjoyed the benefits of operating in a non-restrictive environment, which has enabled them to expand rapidly into international markets. They reversed their attitude toward economic regulations and became the biggest advocator of liberalization by lobbying the government for as many as possible Open Skies deals with the rest of the world, so as to allow them to take the advantage to penetrate into the markets for global coverage.

Majority of the large carriers such as United, Continental, Delta, Northwest (part of Delta since 2007), American, FedEx, UPS and Polar Air Cargo have flown to China and are committed to remaining focused on this market over the long term where the future revenue growth is going to be (Yamanouchi, 2010). United bought its China route licence from Pam Am in 1986 and has since remained the biggest carrier in the Sino-US market in terms of capacity provided. FedEx and UPS operate all-cargo flights between the two countries with their regional hubs being established in Guangzhou and Shanghai in 2005 and 2007 respectively, which enable them to further expand their freight

operations in the Asia Pacific region. Table 6.1 summarises the US carriers operating in the Sino-US markets.

Table 6.1 US designated carriers in the Sino-US markets before the end of 2010.

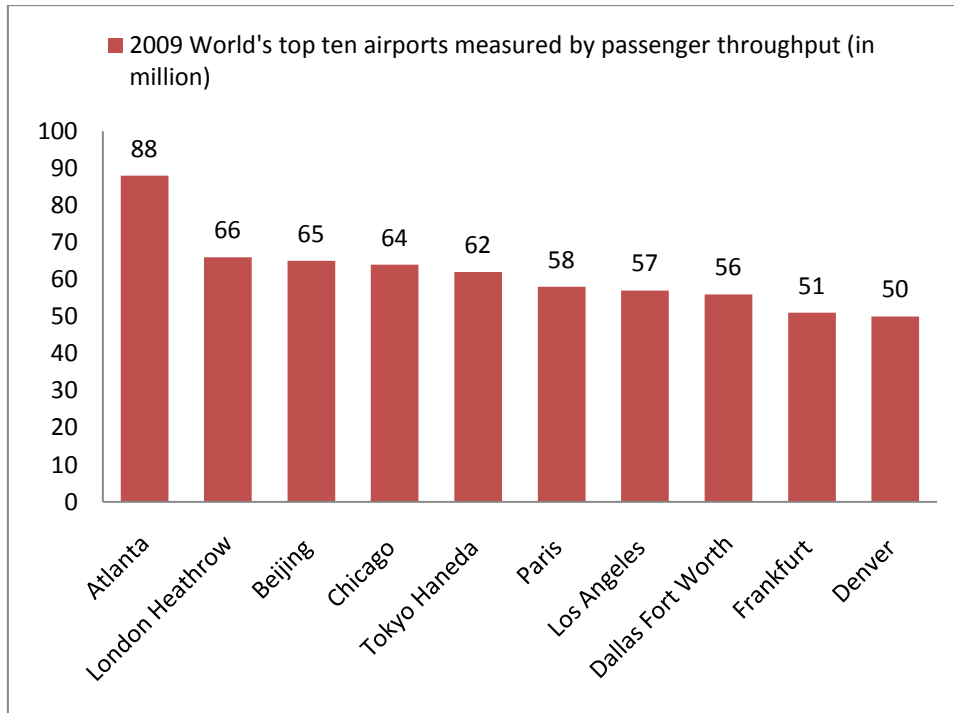
Carrier	Year into market	Destinations in China
United	1986	Beijing Shanghai Guangzhou
Northwest	1984	Beijing Shanghai Guangzhou
Continental	2006	Shanghai Beijing
Delta	2008	Shanghai
American	2006	Beijing
FedEx	1993	Shanghai Beijing Shenzhen Guangzhou (hub)
UPS	2001	Shanghai (hub) Guangzhou

Polar Air Cargo	2004	Shanghai Beijing
Evergreen International	2009	Shanghai
Kalitta Air	2010	Shanghai

Source: www.caac.gov.cn

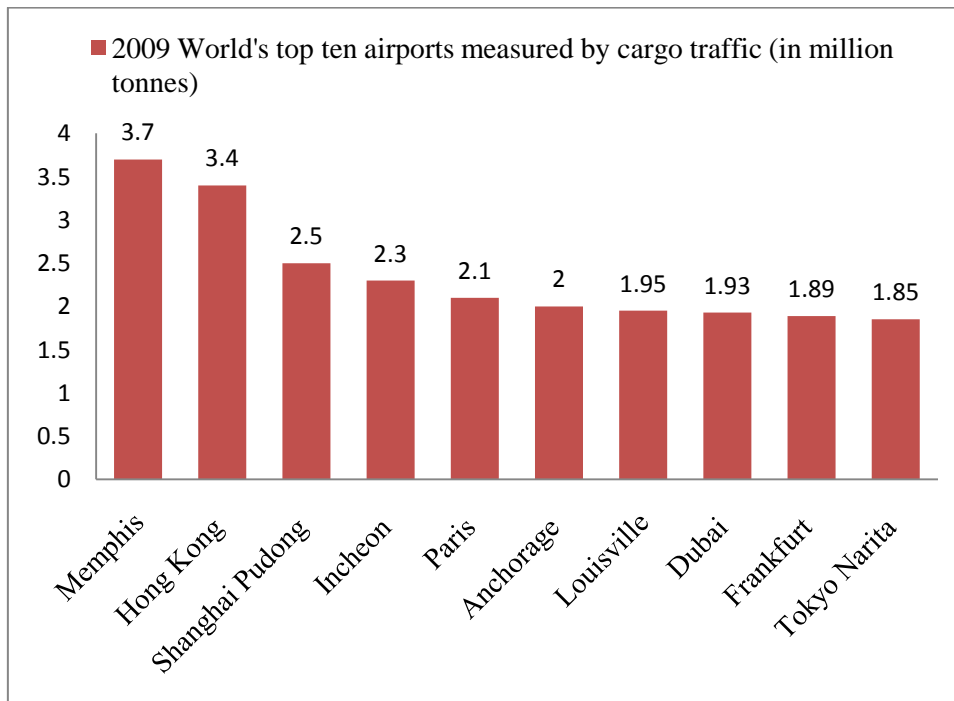
In addition to being the most competitive airline industry, the US also claims to embrace the busiest airports of the world. In the domestic market, Atlanta Airport was the busiest airport in the US in 2009 with 42 million passengers enplaned, followed by Chicago's O'Hare with 31 million and Los Angeles with 27 million (ATA, 2010). Internationally, according to ACI, of the world top 10 airports measured by passenger throughputs in 2009, 5 were US airports, with Atlanta taking the 1st place reporting 88 million passenger throughputs (Figure 6.1). In terms of cargo traffic, Memphis ranked world No. 1 recording 3.7 million tonnes of freight in 2009, with Anchorage taking 6th place with 2 million tonnes and Louisville the 7th with 1.95 million (Figure 6.2). Of the total of more than 2000 airports in the US, 12 have direct services to China which include New York, Chicago, Detroit, Atlanta, Seattle, Los Angeles, San Francisco and Honolulu for passengers and Memphis, Portland, Anchorage, Chicago, Orlando, New York, Los Angeles and San Francisco for cargo operations.

Figure 6.1 World's top 10 airports measured by passenger throughputs in 2009.



Source: ACI

Figure 6.2 World's top 10 airports measured by cargo traffic in 2009.



Source: ACI

6.2 World leader in liberalizing its domestic market and champion in promoting Open Skies in the international air transport market

The US is undoubtedly the world leader in liberalizing both its domestic and international air transport markets and has been persistently pressing other countries to follow suit. Back in 1944 when the Chicago Conference was held, the US was one of the few nations that advocated a free regime for international air transport to allow competition for efficiency and productivity. It argued that a multilateral mechanism toward international air transport operations would be the most beneficial to the world economy and would help create an unrestrictive environment to nurture a commercial air transport industry, which is vital to the prosperity and security of Americans (DoT, 2006). However, due to the opposition from other nations that had concerns about being taken advantage of by US carriers, the US failed to convince the attendees at the Conference to accept its proposals. Two years later, it concluded the Bermuda I agreement with the UK, which set the model of bilateral negotiations on international air transport operations with a nation's government being the key negotiator and decision maker to determine how airlines should operate cross-border flights in terms of market entry, frequency, capacity and pricing.

The US has never given up its efforts to remove the restrictions on airline operations. Inspired by the liberal ideas advocated by politicians and economists in the 1970s, the US government took the initiative to demolish the economic regulatory controls on the operations of its airlines, thus being the first to have deregulated its domestic air transport market. With the determination of Presidents Carter and Ford, the support of Senators, bureaucrats in the Civil Aviation Board (CAB) and academics, the US passed the "Airline Deregulation Act" in 1978, which removed the government's interference in airline operations to allow free competition in terms of route entry, capacity and pricing, despite the move being harshly resisted by airlines, airports and other stakeholders.

The empirical evidence of the benefits of liberalising the domestic market made US carriers very innovative in terms of adopting innovative strategies for further expansion. Seeing the benefits enjoyed by its carriers and consumers, the US government officially

announced its international air transport policy, e.g. Open Skies, in 1995 (Havel, 2009) which was designed to knock down the protection barriers for an open and free environment for global operations. Believing that a fully liberalized market will provide the most competitive service for the price-sensitive consumers, the US government has since launched campaigns worldwide to promote the concept by deploying “beggar-thy-neighbour” (Button, 2004) tactic in bilateral negotiations to convince its trade partners of the merits of the conclusion of the deal. The objective is to seek agreements that do not limit the number of carriers that may serve, the capacity that they offer, or the prices that they charge (www.state.gov). “We will liberalise international transportation markets, expand the capacity of our freight and passenger transportation systems, improve intermodal connections, and ensure the adoption of new technologies, procedures and infrastructure improvements” (DoT, 2006). “Open Skies has been our ultimate objective in promoting international air transport to facilitate globalization and economic prosperity of the world” (Steinberg, 2007). “The US will make every effort to promote the deal for an environment for a more competitive international air lines industry” (Steinberg, 2007). To this end, efforts will be made to reduce barriers to trade in transportation of goods and services and to maintain a sustainable international leadership in promoting US transportation policies and to enhance the competitiveness of US transport providers and manufacturers in the global marketplace (DoT, 2006). The efforts have brought about rewards. In November 2010, the US signed its 100th bilateral Open Skies agreement with Colombia, which was about 18 years after the first such Open Skies was signed with the Netherlands in 1992.

Among those that have not concluded such agreements is China. With a population of well over 1.4 billion with a GDP of one trillion US dollars, China’s passenger aviation market only stands at approximately one fifth the size of the US market, which indicates the enormous potential for growth and represents a real gold mine for the US airlines (Meyer, 2002). Over the years, the bilateral trade between China and the US has continuously grown, with China overtaking Japan to become the second largest trade partner for the US and holding a tremendous amount of its foreign debts. The booming of the bilateral trade has benefited the air transport industry, with the US carriers diverting more of their focus to this market and the Asia Pacific region, which passed North America in 2009 as the world’s largest regional aviation market and will remain

to be the most profitable region for the world's airlines (IATA, 2010). China is the one that the US has been targeting at, which represents all the potential of the growth of the industry for the US carriers (Steinberg, 2007). To this effect, the US would like to see an Open Skies agreement to be achieved within a foreseeable timescale with China so as to enhance the overall comprehensive cooperation between the two parties.

6.3 The government agencies responsible for international air transport policymaking and bilateral negotiations

Due to the nature of the primacy of international law over domestic law in aviation, different countries have developed different structures concerning international aviation matters. For the US, air transport negotiations are truly intergovernmental with political as well as economic implications (Havel, 2009), with the DoS being involved in international aspects of air politics and diplomacy and taking the leading role, joined together by the DoT and the Federal Aviation Administration (FAA). The President of the United States has the final say on US policy decisions on international aviation matters.

Within DoS, the Transportation Affairs division in the Bureau of Economic, Energy and Business Affairs (EEB/TRA) is devoted to providing the fullest possible support to the US global transportation industry. With a goal of creating a world-wide transportation system that is open, efficient, secure and safe for the rapid and economical movement of people and goods, EEB/TRA aggressively promotes liberalization of safe and secure air and sea transportation to spur economic development, and to expand opportunities for US firms, jobs for U.S. workers and benefits for US consumers (www.state.gov). Headed by the Chief Negotiator, the Office of Aviation Negotiations (OAN) within EEB/TRA manages US bilateral aviation relationships and leads the US team to negotiate Open Skies and other aviation liberalization agreements with nations around the world. In close coordination with the Department of Transportation (DoT) and the private sectors, the Office seeks to achieve Open Skies with the US trade partners with the aim of liberalising the commercial environment to remove restrictions on competition so as to allow US carriers to compete freely on a global scale wherever

possible and to maximise market access for the optimisation of opportunities available for global expansion (www.state.gov).

The Office of Transportation Policy (OTP) within EEB/TRA develops and coordinates policies on international civil aviation, maritime, and land transport issues, including policy research, safety and security, discriminatory and unfair practices, commercial and operational problems encountered abroad, overflight/landing authorizations, port access, environmental protection and accident investigations. The OTP also participates in the development of policy on international civil aviation issues with broad substantive and/or multinational application, such as those involving ICAO and the EU. The two offices work closely together on aviation issues to drive forward US air transport strategies.

The DoT is the industry regulator. Under the Secretary of Transportation, the Office of Aviation & International Affairs and the Office of Transportation Policy are both involved in aviation policy issues. The key functions of the Office of Aviation & International Affairs include: providing policy advice and policy recommendations to the Assistant Secretary for Aviation on issues involving international civil aviation, including bilateral and multilateral aviation negotiations; serving as the Department's representative at formal and informal bilateral and multilateral air transportation negotiations and providing policy guidance and technical and analytical support to other US agencies during negotiations (www.dot.gov). The Office of Transportation Policy is responsible for recommending overall surface transportation policy initiatives to the Secretary, by conducting economic analyses to make sure that the recommendations are to the best benefit of the country, business, and consumers. The DoT employs the most experienced staff analysing all sources of data available with respect to air transport, so as to provide sound policy advice and suggestions to the relevant organisations.

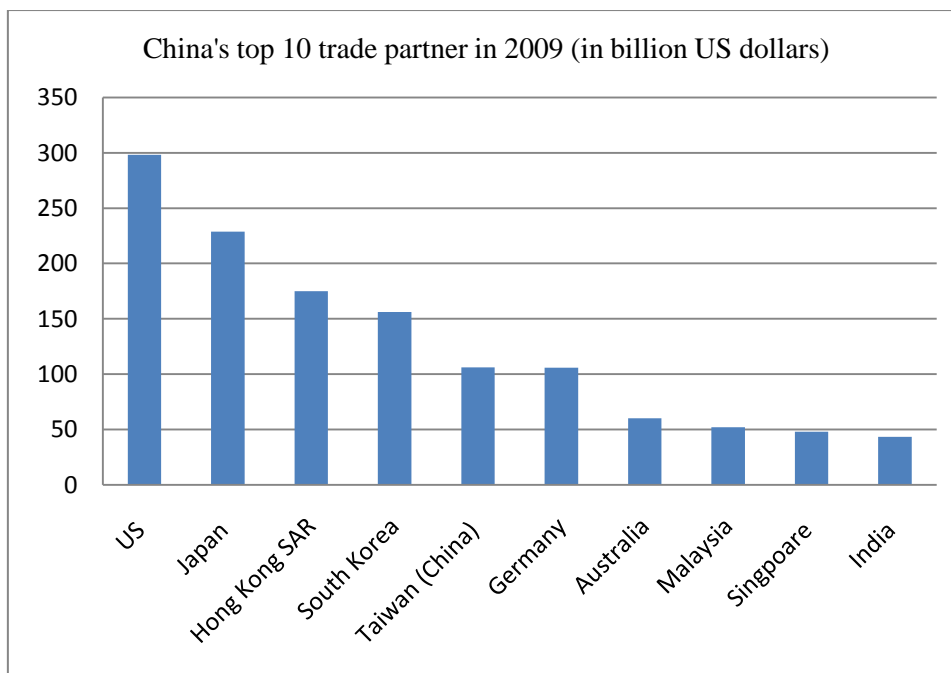
The FAA oversees the safety issues of civil aviation. The Office of Aviation Policy, Planning and Environment leads the agency's strategic policy and planning efforts, coordinates the agency's reauthorisation before Congress, and is responsible for national aviation policies and strategies in the environment and energy arenas, including aviation activity forecasts and economic analysis. The Office of Government and

Industry Affairs is the principal advisor and representative on matters concerning the Congress, aviation industry groups, and other government organisations. The FAA is also involved in bilateral aviation negotiations, though only playing a supporting role (www.dot.gov).

6.4 Sino-US trade relations

Since China's economic reform in 1978, the country has emerged as a leading global manufacturer (Tanger, 2007), becoming a driving force for international trade with trade volume expanding dramatically. Its worldwide trade was valued at \$2.21 trillion in 2009. In 1989, about 24.4 percent of Chinese exports went to the US. By 1998, the figure jumped to 38.7 percent, making the US China's biggest trading partner. In 2009, China's trade value with the US was \$298.3 billion, followed by Japan, Hong Kong SAR, and South Korea as shown in Figure 6.3. From the US perspective, trade with China of \$18 billion in 1989 had grown to \$343 billion in 2006, with the country overtaking Japan to become America's second largest trading partner after Canada, up from 10th largest in 1989.

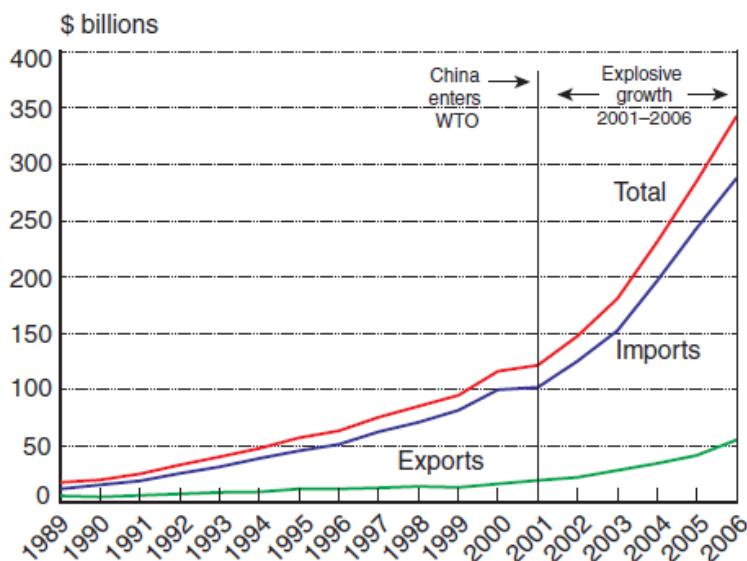
Figure 6.3 China's Top 10 Trade Partners in 2009 (in billion US Dollars).



Source: www.uschina.org

Compared with US imports from China, its exports to China have been far less. Statistics showed that the US imported \$288 billion of merchandise in 2006, but only exported \$55 billion of goods to China. Of the total trade volume between 1989 and 2006, US imports increased by 2,300 percent, compared with an 851 percent increase in US exports to China. The accession of China to the WTO in 2001 allowed the country to reduce barriers to the importation of products from other nations, leading to a marked increase in US-China trade between 2001 and 2006 with an average of 23 percent per annum compared with an average of 14 percent per annum for the previous 5-year period (Beningo, 2008). The increase was phenomenal when compared with the US trade with other East Asian countries such as Japan and South Korea, which grew at 3.5 percent a year between 2001 and 2006 (Beningo, 2008). Figure 6.4 shows Sino-US trade between 1989 and 2006 with US imports exceeding its exports to China.

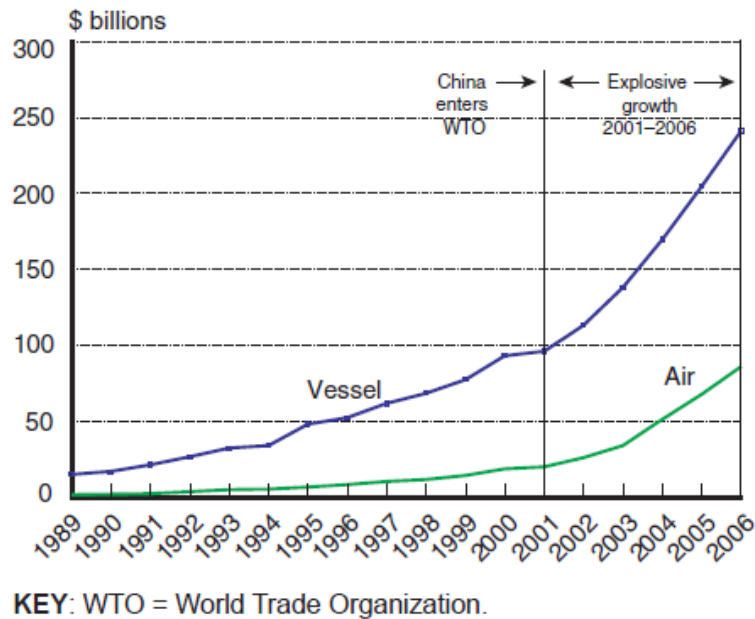
Figure 6.4 US imports from and exports to China between 1989 and 2006.



Source: Beningo (2008)

The remarkable increase of bilateral trade stimulated the air transport market between the two countries, with the total trade by air increasing from just under \$2 billion in 1989 to over \$86 billion in 2006 (Beningo, 2008). This was more than a 4,400 percent increase, averaging 32.1 percent per annum between 1989 and 2006. Figure 6.5 shows the value of US-China trade by air compared with vessel between 1989 and 2006.

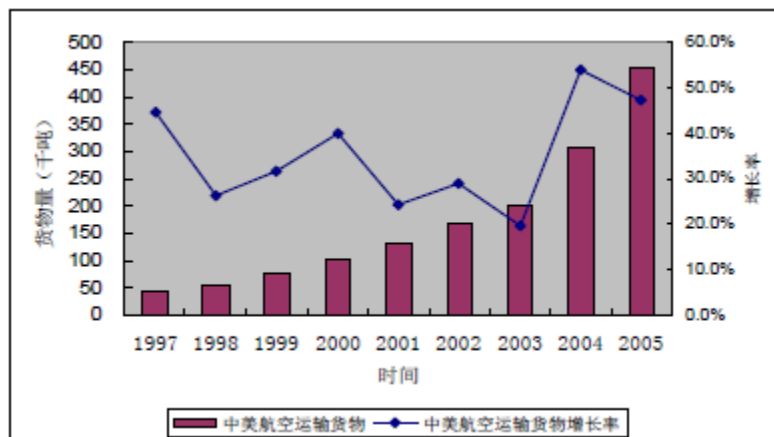
Figure 6.5 Value of US-China trade by mode 1989-2006.



Source: Source: Beningo (2008)

When measured by volume, cargo carried by air increased from less than 5,000 tonnes in 1990 to more than 30,000 tons in 1996 and up to 450,000 tons in 2005, averaging 34.8 per cent increase year on year. For Chinese carriers, Sino-US cargo accounted for only 8.9 percent of its international traffic in 1996. The figure jumped to 23.2 percent in 2004 (www.caac.gov.cn). Figure 6.6 reflects the increase in air cargo volume between the two nations and the change from 1997 to 2005.

Figure 6.6 Cargo traffic from 1997 to 2005.



(Remarks: The red column is the total tonnage of freight carried between the two countries and the blue line is the change rate. Unit in thousand tonnes).

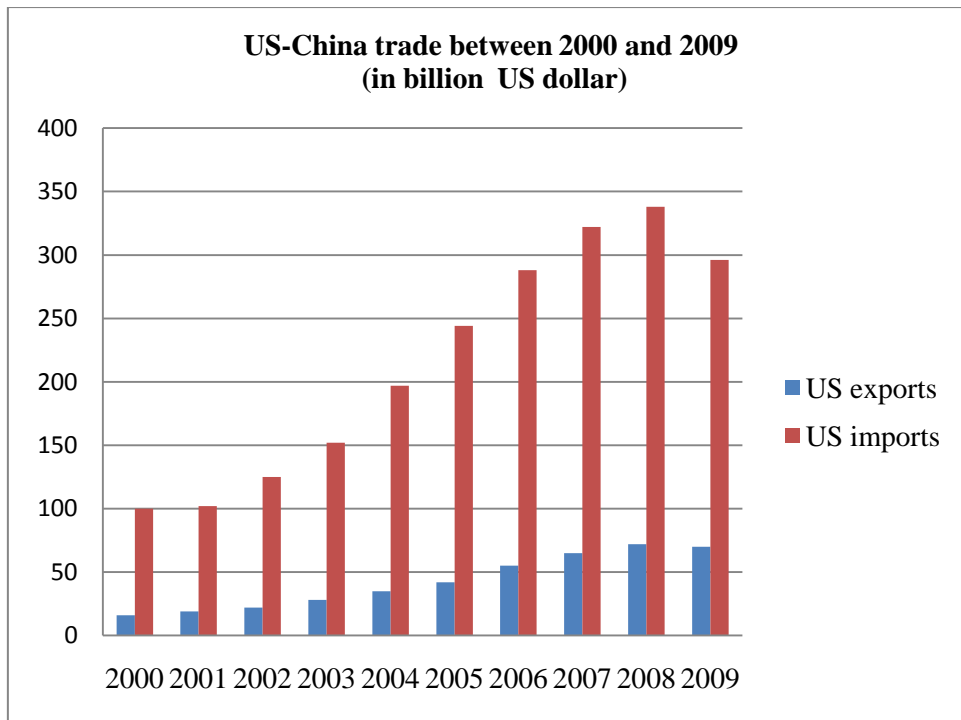
Source: Civil Aviation University of China, 2006

The robust trade growth is also reflected in the load factor of the carriers. Statistics shows that the load factor of all carriers carrying eastbound cargo from China to US destinations has remained at an average of 95 percent, although westbound flights from the US to Chinese destinations were expected to achieve load factors up to 35 percent at the best (Tanger, 2007). For example, Northwest Cargo reported a load factor of averaging 96 percent from China to the US in 2003 and 2004, while FedEx recorded a 98 percent load factor in 2004 from Shanghai to the US. All Chinese carriers including Air China, China Cargo and China Southern reported an average of more than 90 percent load factor from China to the US, with the westbound less than 30 percent (www.caac.gov.cn).

China's trade expansion was not only contributed to by its rapid continuous economic growth, but also by the type of manufactured products the country has invested in over the years (Tanger, 2007). The sophisticated electronic and high-tech goods including computers, mobile phones, and flat-screen televisions that require air shipment represented 58 percent of China's exports to North America and Europe compared to a 38 percent share in 1995 (Tanger, 2007). On the other hand, imports from the US to China typically include intermediate materials and capital equipment that support China's manufacturing requirements, thus leading to an imbalance in bilateral trade.

As a consequence, the trade deficit has grown rapidly from minus \$83.7 billion in 2000 to \$226.8 billion in 2009 for the US side. Figure 6.7 shows the trade values and the changes between the two nations from 2000 to 2009, revealing the dramatic increase of the US trade deficit with China over the period.

Figure 6.7 US China trade between 2000 and 2009.



Source: www.uschina.org

Compared with the trade of merchandised goods, the movement of people between the two countries has not been as impressive. Although tourism started in China in the early 1950s, the country had remained an inbound destination until the 1980s as outbound travel by Chinese citizens for leisure purposes was not permitted (Lim and Wang, 2008), one of the reasons being that the movement of people is not merely an item of trade but also involves issues of citizenship, visas and migration (Clancy, 2007). In the late 1980s around 95 percent of airline passengers in China were foreigners with only 5 percent being Chinese citizens (Lapmton, 2001). Compared with South Korea which has had a more balanced inbound and outbound traffic, between 1996 and 2000, China had consecutively had almost four times more inbound visitors than its outbound tourists (Table 6.2) (Zhang and Chen, 2003).

Table 6.2 International inbound/outbound tourists in three nations in Northeast Asia (in thousand).

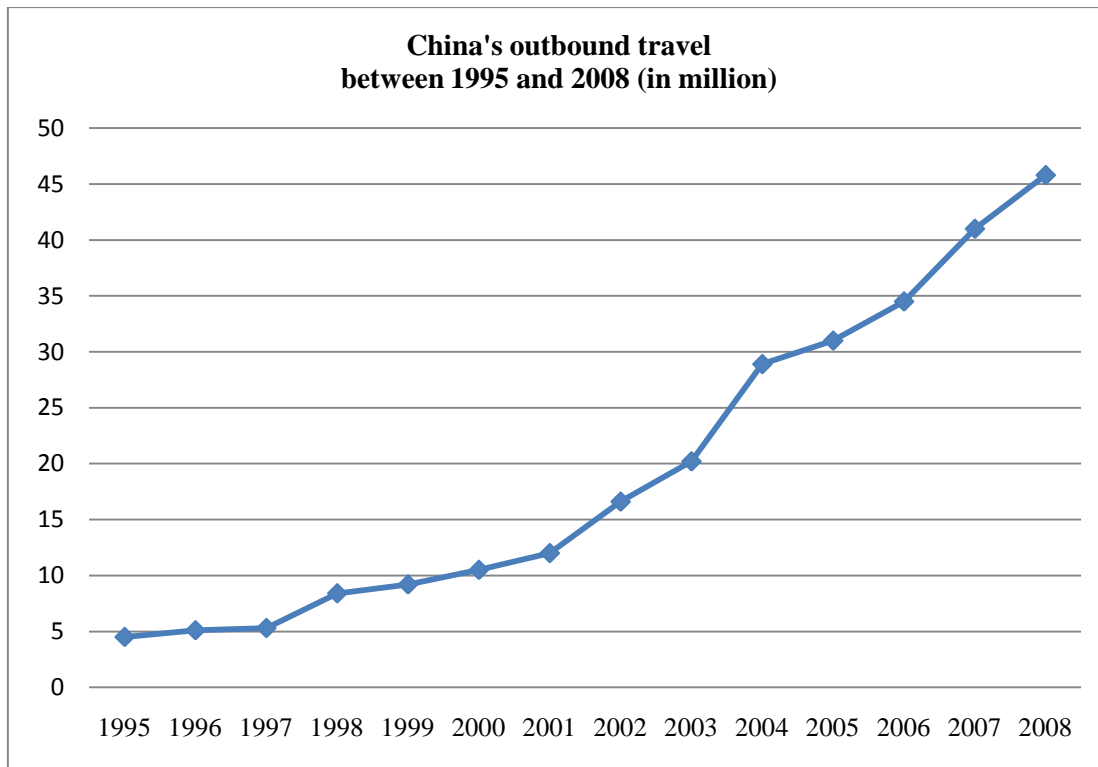
	China	Japan	South Korea
--	-------	-------	-------------

Year	Outbound	Inbound	Outbound	Inbound	Outbound	Inbound
1996	5,601	22,765	16,694	4,244	4,649	3,684
1997	5,936	23,770	16,802	4,669	4,542	3,908
1998	6,505	25,073	15,806	4,556	3,067	4,250
1999	9,200	27,047	16,357	4,901	4,342	4,660
2000	10,500	N.A	17,818	5,272	5,508	5,322

Source: Adapted from Zhang and Chen (2003)

The situation started to change since the late 1990s with China's marked economic growth which has improved the living standards of Chinese people and generated a burgeoning middle-class group, thus stimulating the demand for air travel. The gradual relaxation of regulatory restrictions on international air transport has enabled the growth of China's outbound travel market, with the World Tourism Organisation estimating that China would be the world's fourth largest international tourism market by 2020, representing 6.4 percent of the total, with nearly 100 million outbound travellers (Lim and Wang, 2008). According to CNTA, between 1995 and 2008, the number of Chinese residents travelling outside China increased from 4.5 million to 45.8 million, averaging more than a 10 percent increase year on year (Figure 6.8).

Figure 6.8 China's outbound travel since 1995 (in million).



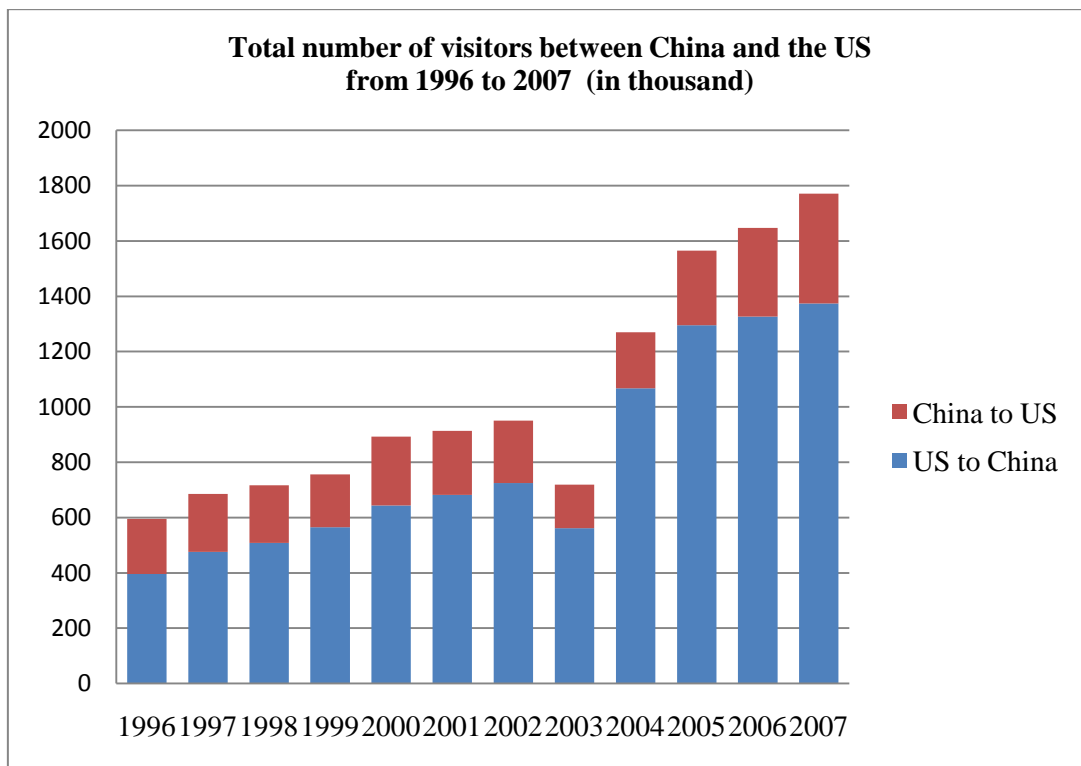
Source: www.cnta.gov.cn

The US has always been a popular destination for Chinese travelers although the Approved Destination Status (ADS) had not been granted until December 2007, which officially endorsed the US to market itself in China and allowed Chinese tour operators to organize group tours for Chinese residents for leisure purposes. Data from CNTA revealed that in 1996 there were 199,000 Chinese visitors to US. The figure increased to 397,000 in 2007, being the only long-haul market in the top ten Chinese tourism destinations with a total spending of \$2.7 billion (www.tinet.ita.doc.gov). From the US perspective, together with Hong Kong SAR, China stood at 12th in generating visitors to the US in 2007, 18 percent increase than 2006. Of the 397,000 visitors that year, 58 percent was leisure travelers, despite the fact that there is no visa-waiver system between the two countries and limits on the sale of Chinese group leisure travel are still in place (www.tinet.ita.doc.gov).

Statistics from the US Department of Commerce (DoC) shows that US visitors to China have been growing steadily over the years, making China one of the hottest destinations

for US citizens. In 1996, the total number of US citizens visiting China was only 396,000. The figure jumped to 1.37 million in 2007, making China the 16th largest international market for the US. From China's perspective, the US was the 4th largest tourist source country, just behind South Korea, Japan, and Russia. Figure 6.9 provides a detailed breakdown of tourists between the two countries from 1996 to 2007. The total number of visitors grew from 595,000 in 1996 to 1.77 million in 2007, with the US generating 978,000 tourists to China while China only produced 198,000 visitors to the US.

Figure 6.9 Total number of visitors between the two countries from 1996 to 2007.

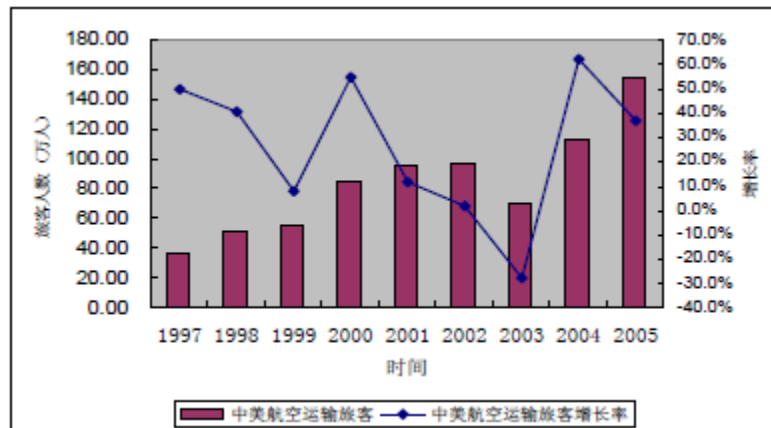


Source: Zhang (2009).

The rise in the number of tourists has been reflected by the increase in air passengers between the two nations. Statistics from CAAC and DoT showed that in 1990, the total number of passengers travelling by air was less than 90,000. The figure rose to 240,000 in 1996 and jumped to 1.5 million in 2005, averaging 18.9 percent annual increase. In 1996, of all the international passengers carried by Chinese airlines, only 3.8 percent comprised Sino-US traffic. In 2004 when the more liberalized bilateral protocol was

signed, the percentage of Sino-US traffic rose to 5.5. Figure 6.10 shows the steady growth of air passenger traffic between the two countries year on year except 2003, which was affected by SARS in the Asia-Pacific region, causing airlines to ground most of their aircraft.

Figure 6.10 Sino-US air passenger traffic between 1997 and 2005.



(Remarks: The red column shows the total Sino-US air passenger numbers per annum the blue line is the percentage of increase rate. Unit in 10,000).

Source: Civil Aviation University of China, 2006

The expansion of economic ties, in particular bilateral trade, brought with it both positive and negative consequences for both countries and their relations (Lampton, 2001). Positively, the US's increased direct investment in China, which stood at \$82.7 billion in 2007, helped create a significant number of jobs in the US, while made-in-China products provided US consumers with low-cost, good-quality products. The US multinational corporations such as Boeing, Coca Cola, and Motorola are able to develop products and services for international consumers and expand into the local Chinese market with a growing market share. It also helped China to develop its export-oriented economy, accumulate foreign reserves and facilitate its collaboration with the international community. Negatively, the economic interdependence, in particular the trade imbalance, develops into trade friction and carries with it political implications, which has increasingly become a hot issue that both parties are challenged to address. Demanding market access for US enterprises is one of the themes that the US side

would always request in any communications with the Chinese side, with an aim of generating more opportunities for the US enterprises to penetrate in Chinese market and reducing the trade imbalance.

6.5 Sino-US air transport relations

Since 1980 when the Sino-US bilateral ASA was signed, six major amendments have been made in 1982, 1992, 1995, 1999, 2004 and 2007 respectively which have substantially relaxed the restrictions on airline operations and facilitated bilateral trade. Barriers to market entry were removed, capacity was increased and price control was lifted which has enabled unlimited designation of carriers operating between the two countries to satisfy the market needs. The following is a detailed examination of the bilateral air transport relations which reveal how the restrictions have been gradually eliminated to embrace a liberalized trade deal between the two countries.

6.5.1 Establishment of bilateral air services relations

There were no diplomatic ties between China and the US between 1949, when the new PRC was established, and 1972, when the then American President Richard Nixon extended his hand to Premier Zhou En'lai, indicating a willingness to end the hostility of more than 20 years. However, Nixon's historical visit only brought about the first order of 10 Boeing 707 aircraft from the Chinese side to serve its market rather than the rapprochement of diplomatic ties due to the divergent and contrasting views on certain issues. It took another six years for both parties to conclude the Joint Communiqué of China and the USA concerning the establishment of their diplomatic relations in December 1978, which declared that "Starting from January 01, 1979, the Chinese and American sides will acknowledge each other and establish diplomatic relations", thus putting an end to almost 30 years of mutual estrangement between the two countries.

In the 1980s, China started its economic reform and was very keen to attract foreign direct investment, to import the technology, and to promote its exports to the western countries including the US. As an element of the diplomatic relationship, a bilateral ASA was signed in Washington D. C in September 1980 by the visiting Chinese Vice Premier Bo Yibo and the then US President Jimmy Carter. Unlike most of the ASAs in

those days that China had concluded which only permitted one flag carrier to fly between the capital cities, the deal with the US allowed two carriers from each side to operate on two routes (Route A and Route B) (Table 6.3) with two weekly frequencies. For the US side, both the capital city Beijing and the most commercial city of Shanghai were allowed for operations, while for the Chinese side, four cosmopolitan cities rather than the capital city of Washington were given, namely New York, Los Angeles, San Francisco and Honolulu. Although Route B was in principle agreed in the 1980 discussions, the specific points enroute were not agreed until 1982 when a second consultation was held with Guangzhou being included.

Table 6.3 Sino-US arrangements in 1980.

Items	Agreement
Route A for both sides	Beijing-Shanghai-Tokyo/or another point in Japan-Honolulu-Los Angeles-San Francisco-New York, And v.v.
Route B for both sides	Beijing-Guangzhou-Shanghai-Tokyo/or another point in Japan-Honolulu or Seattle-Los Angeles-San Francisco-Chicago, And v.v.
Number of designated carriers	2 for each side
Frequencies	2 weekly frequencies for each carrier

Source: adapted from Sino-US ASAs in 1980 and 1982

The double designation arrangements were very exceptional in the early 1980s from the Chinese perspective. On the one hand, China's air transport system was regarded as quasi-military services. There were no airlines existing in China that were managed as a corporate business to explore the commercial benefits of air transport. CAAC, as a

subordinate organization reporting to Air Force, acted as a regulator as well as a commercial operator with the IATA code CA. On the other hand, air transport in China was considered as more a political instrument rather than an economic activity. International air links were only made available to those countries that had diplomatic ties with China, with Chinese people travelling by air being strictly scrutinized.

In such a circumstance, double designations for the Sino-US market were not meaningful for the Chinese side as it was for the US, since there was no second carrier available at all in the market to be designated by the Chinese authority. CAAC, the negotiator of the agreement, became the first designated carrier (later replaced by Air China) and launched its Beijing-Shanghai-San Francisco-Tokyo-New York service in January 1981.

Contrary to the case in China where the allocation of the traffic rights involved no more than some paper work, for the US, double designation could only partly satisfy the needs of the US carriers that were all very keen to serve the US-China market. According to Beane (2007), in addition to Pan Am, quite a few major US carriers including Trans World Airlines (TWA), Northwest Orient Airlines (Northwest), United and World Airways started to prepare the China services in the late 1970s, anticipating that a diplomatic relationship would be resumed following the historic visit of President Nixon. Pan Am, TWA and Northwest were even authorized traffic rights by the CAB in 1979. The successful conclusion of the 1980 ASA eventually enabled Pan Am to resume its service to Shanghai and Beijing in January 1981, more than 40 years after its last such operation in 1949.

The politically significant air links did not generate much traffic in the early days of the operations. In 1983, passenger traffic in both directions was only 130,000 and cargo 3,000 tons. Due to the low demand, Northwest did not launch its Seattle-Shanghai service on Route B until 1984, while CAAC did not start its Beijing-Shanghai-Los Angeles (Route B) operations until 1987, being replaced by China Eastern in 1992 with an amended routing Shanghai-Los Angeles-Seattle and Beijing-Shanghai-Seattle-Chicago as a result of the carrier's successful negotiations with the central government to deploy its newly-introduced MD-11 aircraft on long-haul services. By the end of the

1980s, capacity had been only moderately increased to 6 weekly frequencies with no increase in designated carriers.

6.5.2 Discussions in 1992

6.5.2.1 Sino-US political and economic relations before 1992

From the 1980s till 1992, the US had two presidents who were Ronald Reagan and George H.W. Bush. For Reagan, a pro-Taiwan policy was pursued, which threatened Sino-US relations. The Shanghai Communique of 1982 reassured China of the US position in the region, which helped restore the relationship back on course, leading to a recovery of bilateral trade. By the time President Reagan visited China in April 1984, the first in-office US president to visit China after the two nations established diplomatic relations seeking to improve the friendship, China was in the fourth year of a row over a large trade surplus with the US. Statistics available showed that in the first half year of 1983, US exports to China were \$1.1 billion, a 12.4 percent increase over the same period in 1982, while US imports from China increased by 40 percent to \$1.5 billion (Chen and Lee, 1984).

Domestically, the Reagan Administration advocated free competition policy. He allowed the larger incumbent carriers to benefit from a bystanding government, which enjoyed a state of virtual non-regulation to rebuild much of their lost hegemony (Havel, 2009). The relaxed environment encouraged the overhaul of the structure of the US airlines industry, resulting in bigger airlines such as American, United and Delta to adopt hub-and-spoke systems to develop their networks for economies of scale, while start-up carriers delighted the travelling public with new routes and low fares (Havel, 2009). At this time, the US government was not sure about the policy of promoting the liberalization of international air transport to its trade partners, who had been accustomed to the old economic compromises of bilateralism (Havel, 2009), hence the focus remained in the domestic market.

When George H.W. Bush was elected into office in the later 1980s, his goal was to strengthen the relationship with China so as to usher in a new level of stability (Garrison, 2005). The 1989 event in China challenged Bush's policy, leaving him to

press hard to maintain the relationship. In such a complex domestic context, Bush managed to continue the engagement with China hoping to forge a broad role in the architecture of the emerging order in Asia while at the same time countering the Soviet Union. He supported China's economic reform, which, he argued, would eventually lead to political freedom with foreign trade and investment being essential tools to keep China open to the outside world, thus availing an opportunity for the US to have an influence to work for cooperation, which would be a more reasoned, careful action taken given its long-term interests in China (Garrison, 2005).

By maintaining a balanced relationship with China and forging a continuous senior level dialogue and shifting political controversy to China's economic reform and its achievements (Garrison, 2005), Bush supported China's efforts in joining the WTO and managed to retain China's Most Favoured Nation (MFN) status and successfully improved US market access to China to help Beijing make the reform required for WTO membership.

In terms of air transport, the focus of the US government was on improving aviation relations with EU Member States, such as the entrepreneurially-inclined Netherlands that signed the first-ever "Open Skies" agreement with the US (Havel, 2009). The DoT initiated the idea of "Underserved Cities Program" in 1989 so as to allow foreign airlines to provide extra-bilateral international services to and from US city-points that did not otherwise receive the identical international nonstop service from US airlines (Havel, 2009), thus encouraging airlines of the EU Member States to expand their operations on the cross-Atlantic markets. Consequently, the US carriers' attention was also on the US-EU markets rather than on Asia Pacific, including China, where public demand was too low to stimulate the major US carriers to explore the market.

6.5.2.2 Political and economic reform in China

Taking a controlled and progressive approach, China's economic reform initially concentrated on enterprise restructuring by consolidating its property rights and by adopting a new enterprise governance structure which stressed enterprise autonomy and incentives (Li, 1994). The enterprises were encouraged to take accountability of their performance and be responsible for their own losses and profits. Due to the strategic

importance of Chinese airlines which was regarded as part of the military defence forces, the reform of the industry was almost ten years later than that in other industries, with the first airline being formulated based on individual branch of CAAC's regional administration in 1987. CAAC remained to be a regulator responsible for formulating the air transport policies for both domestic and international services as well as a flag carrier operating all routes. Primary efforts were given to steering domestic economic reform of the airline industry, with international operations being considered a subordinate activity, with CAAC consulting and reporting to the MFA to ensure that the negotiation results were to support China's political objectives and that the air links between a third country with Taiwan was of a commercial nature with no political implications.

6.5.2.3 Agreement reached in 1992

In this context, the China-US consultation held in 1992 brought about the first relaxation since the conclusion of the ASA. It was agreed that a third carrier would be allowed to enter into the market, which could be either an all-cargo operator or a passenger airline with cargo business to introduce all-freight services to the market. The new designated carrier would be given the right of flying between any points in the US and any airports that were open for international operations in China via any intermediate points and further to any beyond points with full traffic rights. This was a very innovative and exceptionally relaxed arrangement in the early 1990s, taking into account that there were no all-cargo operators existing in China at all. For the US, the agreement represented a remarkable achievement in Asia Pacific, given the fact that it had just concluded an Open Skies agreement with the Netherlands which allowed free operations between the two countries. In terms of capacity, both sides agreed to increase the weekly frequency to 27 for each side by 1996 through phased-in arrangements compared with the previous 6 weekly frequencies). In addition, both sides agreed to approve any commercial arrangements reached between the carriers including wet leasing, block seats and codeshares (Table 6.4).

Table 6.4 Key points in the Agreement reached in 1992.

Item	Contents
Route A	Beijing-Guangzhou-Shanghai-Tokyo/or another point in Japan-Honolulu-Los Angeles-San Francisco-Chicago-New York v.v
Route B	Beijing-Guangzhou-Shanghai-Tokyo or another point in Japan-Honolulu or Seattle-Los Angeles-San Francisco-Chicago v.v.
Cargo route	Any point in its own country-any intermediate points-any points open for international operations in the other country-any beyond points, with full traffic rights
Number of designated carriers	3 for each side
Weekly frequencies for each side	18 for 1991-1992 20 for 1993—1994 27 for 1995-1996

Source: adapted from the 1992 ASA

The 1992 arrangements allowed Evergreen International (later replaced by FedEx) from the US side to start an all-cargo service on the route New York-Chicago-Anchorage-Beijing-Shanghai in September 1993 and Air China to introduce an all-cargo service from Beijing to New York via Shanghai and Anchorage from the winter season of 1993. Traffic grew rapidly for the following two years with both sides being convinced that there was a need for further discussions before the capacity limitation was reached.

6.5.3 Consultations in 1995 and 1999

The years leading to the 1995 and 1999 discussions meant very differently for both China and the US. This was the decade when Sino-US political relations went through a dramatic up-and-down due to the economic sanctions imposed on China after the June 4th Incident, the US arms sale to Taiwan, the permission of Li Denghui's visit to the US in 1995, and the bombing of the Chinese Embassy in 1999 although the interrelated economic links were ever strengthened. The US government had successfully concluded tens of Open Skies agreements with the EU Member States, which resulted in the EU to accelerate its pace of unification of its air transport market. As liberalisation had shown its impact on airlines operations as well as the benefits perceived by the consumers, the US government was increasingly determined to promote Open Skies around the world and, thus, shifted its focus to the Asia-Pacific countries.

6.5.3.1 The US's China policy

In his first term, President Clinton tried to define his relationship with China according to their ideological differences, though he shortly abandoned this to adopt a more pragmatic approach instead. Focusing on commercial relations in his China policy rather than the traditional security issues, which was a marked shift from his predecessors, Clinton was convinced that engaging China to promote its economic liberalization would eventually enlarge democracy (Garrison, 2005). Although this caused some incompatibility between his foreign policy and domestic policy priorities, Clinton managed to balance trade and human rights issues by choosing economy as the central theme. He delinked the MFN with human rights issues in 1994, arguing that the US had strategic, economic, and regional concerns beyond human rights and that there was nothing contradictory between American ideals and commercial interests in China with his supporters voicing that the commercial relationship would serve as the important first steps to make military dialogues possible. McDonnell Douglas was able to seal a deal with China to provide the country with commercial aircraft worth \$1.6 billion, which were later used by China Eastern to launch its first-ever international long-haul route to serve the US.

Clinton's second term saw a fluctuation in Sino-US relations, a critical time when China was in the final throes of applying for membership of the WTO. A fear appeared that China could emerge as an Asian power, which could be a threat to the US' interests in the region, causing the US ruling military elites to demand a far more unilateral US military and diplomatic policy against China (Head, 1999). They argued that containment policy would be a more realistic way to deal with the prospect of a powerful China and efforts should be concentrated on slowing down its economic growth and preventing China from upgrading its military capabilities (Khalilzad, 1999). A series of events fueled the tension, resulting in bilateral relations plummeting to their lowest, including the belated intelligence claims that a Chinese spy obtained US nuclear secrets, criticism about China's threat over Taiwan, the jailing of political dissidents and a widening trade gap (Head, 1999). Then came the deliberate bombing by NATO of the Chinese Embassy in Yugoslav during the war in Kosovo (Sweeney et al, 1999), which infuriated the whole of China, causing the biggest ever anti-America nationalism across the nation. The Chinese representative accused NATO of carrying out a war crime at an emergency session of the UN Security Council, the Chinese press carried front-page pictures of the victims of the Embassy bombing, and major cities saw their biggest and angriest demonstrations in response to the bombing. In Beijing about 100,000 people invaded the Embassy district and the residence of the US Consul General in the south-western city of Chengdu was stormed and partially burned (www.bbc.co.uk).

The US and China broke off diplomatic contact for about four months until discussion on China's entry into the WTO softened relations. Clinton eventually was able to push forward his agenda including supporting China's entry into the WTO, arguing that if China was willing to play by the global rules of trade, it would be an inexplicable mistake for the US to say no. He stated that China's entry into the WTO was in the national interest and would represent the most significant opportunity that the US had ever had to create a positive change in China. Through his efforts, Sino-US economic relations expanded to a great extent with China recording in 2001 \$54.3 billion in exports to the US representing a 4.2 percent increase year on year and \$26.2 billion in imports, 17.2 percent up (Wang, 2002). The US had become the second largest trading partner and the largest importer of Chinese products, whereas China was the fourth largest trading partner of the US (Wang, 2002).

6.5.3.2 China's view towards the US

China's multipolarity policy was pursued since the early 1990s, when the Soviet Union collapsed, which dramatically changed the world order. China was convinced that the disappearance of the Soviet Union meant that a multipolar world would be the trend with China being counted as a pole together with the US and Russia. Deng elaborated in 1990 that "the situation in which the United States and the Soviet Union dominated all international affairs is changing. Nevertheless, in the future when the world becomes three-polar, four-polar, or five-polar, the Soviet bloc, no matter how weakened it may be and even if some of its republics withdraw from it, will still be one pole. In the so-called multi-polar world, China too will be a pole. We should not belittle our own independence: one way or another, China will be counted as a pole" (Deng, 1990).

When Jiang Zemin took office in 1989, he followed Deng's view towards the US, believing optimistically that the US's power would soon decline with the rising of other countries such as Japan, Germany and China (He, 2009). To implement the policy, significant efforts were given to boost links with other countries and regions in the world although the Sino-US relation remained to be one of the priorities. For example, China established strategic partnership with Japan, the EU, and Russia, hoping that such an arrangement with other great powers would increase China's balancing capability to countervail the US (He, 2009). At the same time, to promote its multilateral diplomacy, China proactively participated in international organizations to support the development of multilateralism. For example, China joined the Asia Pacific Economic Cooperation (APEC), ASEAN, initiated ASEAN plus China, ASEAN plus Three, and led the Shanghai Five, which became the Shanghai Cooperation Organisation (SCO) (He, 2009).

The fluctuating relationship affected the political exchange between the two countries. There had been no presidential meetings between the two nations for eight years¹² until November 1993, when China's president Jiang Zemin met his US counterpart at an unofficial occasion in APEC in Seattle. The formal meeting between Jiang and Clinton

¹² In 1985, Chinese President Li Xiannian visited the US, which was the first official visit of a Chinese President to the US.

did not happen until two years later in October 1995, when both were attending the 50th anniversary of the United Nations. Jiang's state visit to the US eventually took place in October 1997, when a joint communique was announced confirming that both parties would adhere to the principles in the Sino-US three Communiques and agree on the objectives, principles and guidelines governing Sino-US relations in the 21st century (Zhang, 2008).

Nevertheless, the ups and downs of political relationship in the 1990s did not hinder the dramatic surge in bilateral trade, with China beginning to run a rising trade surplus with the US. In 1990, China's trade surplus was only \$10.4 billion. The figure jumped to \$57 billion in 1998, which was only a few billion less than that of Japan, the US's largest trade-deficit partner at that time (Feng, 2006).

For this period of time, the Chinese government still concentrated its efforts on domestic air transport development, which grew at two digit numbers. Though foreign direct investment in China as well as China's exports had increased dramatically, international air transport was not regarded as a strategic sector that could further facilitate and promote the country's export-oriented economy. Instead, it was still considered as a political instrument to support the nation's diplomatic strategy to promote China's presence around the world. CAAC simply followed the instructions of SC and MFA in dealing with international air transport issues and did its utmost to protect its carriers by being reluctant to lift the restrictions on the air transport markets.

6.5.3.3 US's push for Open Skies in Asia Pacific

For international air transport, Clinton himself was a strong advocator of the US "Open Skies" policy and appreciated the benefits of a more liberal multilateral trade regime. He empanelled the Airline Commission to uncover the structural causes of the parlous financial condition of the US airlines industry, which, in its report, call for the ceiling on inward investment in US airlines to be raised and recommended a multilateral "Open Skies" replacement for the patchwork of bilateral agreements (Havel, 2009).

The DoT "International Air Transportation Policy Statement" in 1995 was an official declaration of the US government's intention to eliminate the central pillars of the

prevailing Chicago system of protective bilateral agreements (Havel, 2009). Open Skies had since been aggressively pursued around the globe, with Asia Pacific becoming the primary focus from 1996 after the US had successfully conquered some European countries since 1992.

Not surprisingly, a pattern of discord had been shown by Asian countries. For example, Japan expressed continuing discontent with the fifth freedom rights which enabled US carriers to combine at Tokyo traffic flows from a variety of US cities for onward transit to multiple destinations in the Asia/South Pacific market (Havel, 2009). Australia maintained a striking conceptual separation between its highly deregulated and denationalized domestic aviation marketplace and the classic bilateral aerodiplomacy through which it aggressively stewarded its international markets to safeguard the interests of its privatized flag carrier, Qantas (Havel, 2009). Notwithstanding the opposition, the US was successful in convincing Asian countries to conclude “Open Skies” agreements using the same tactics of “beggar-thy-neighbour”. Following the agreement with Macau SAR in 1996, Singapore, Taiwan, South Korea and Thailand all agreed “Open Skies arrangements with the US through protocol or exchange of notes (Havel, 2009).

6.5.3.4 Airlines performance

For China, its continuous economic boom in the 1990s had led to a phenomenal surge in the demand for air transport. In 1999, a total of 60 million passengers were carried compared to 11.5 million in 1987 (Meyer, 2002), representing a 5.3 fold increase year on year. However, the explosive growth had led to spate of air accidents leaving 642 casualties between 1989 and 1994 (Meyer, 2002), which resulted in tight controls in terms of market entry and pricing being imposed by the Chinese government. The financial crisis in Southeast Asia in 1997 also had a severe impact on the profitability of Chinese carriers, which collectively lost \$294 million in 1998 and another \$200 million during the first six months of 1999 (Meyer, 2002). The three carriers in the Sino-US market, e.g. Air China, China Eastern and China Southern¹³ were only able to carry

¹³ China Southern first entered the Sino-US market in 1997.

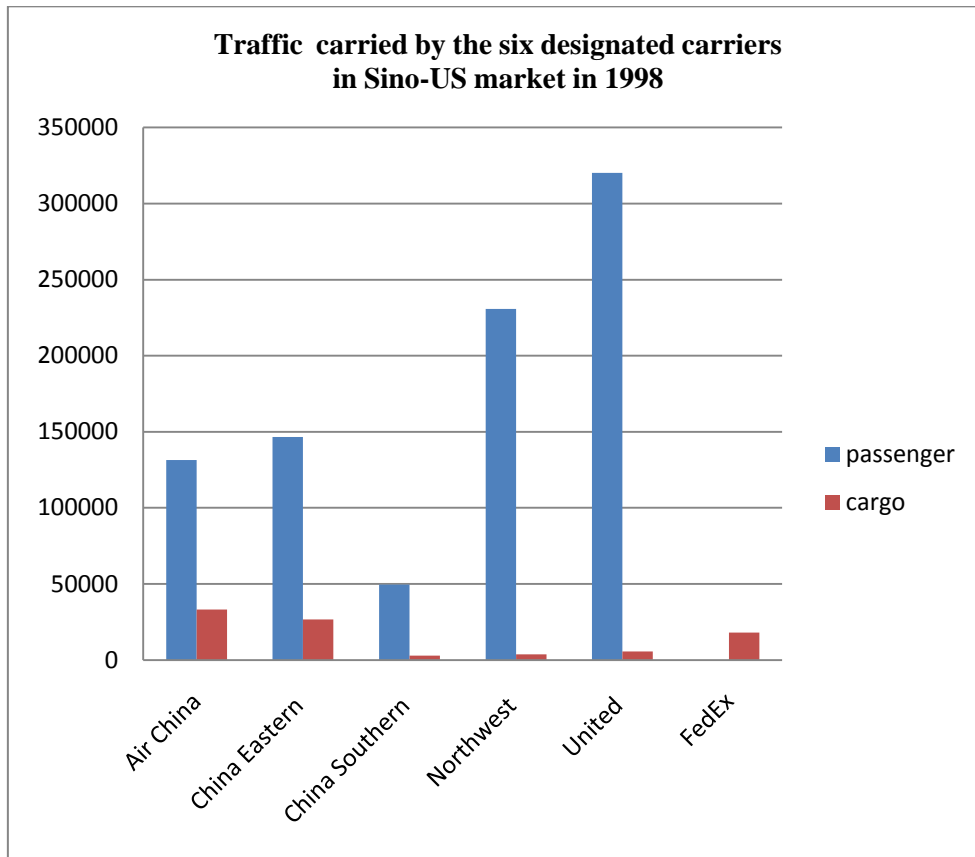
327,540 passengers and 62,700 tonnes of air cargo collectively in 1998 with an average 56.9 percent load factor on all their international routes (Meyer, 2002).

In contrast, the US airlines had experienced a golden period of growth and prosperity after enjoying two decades of deregulated operational environment in the domestic market. The powerful sales and marketing tools such as CRS and FFP as well as strategic hub-and-spoke network system had underpinned the strength of US carriers in both domestic and international markets. The Open Skies agreement concluded with 31 partners by 1998, five of which were Asian economies (www.state.gov), had created a liberal environment for US carriers to expand aggressively into global markets, especially in Europe. Codeshare arrangements had facilitated the US carriers to bypass the stringent bilateral restrictions to further optimize their hub-and-spoke network benefits and exploit market opportunities.

In addition, the US carriers had enjoyed handsome profits for several years. For example, United and Northwest, which had been operating to China for over a decade, had remained highly profitable into the late 1990s, posting annual profits in 1999 of \$1.24 billion and \$300 million respectively (Meyer, 2002). The two airlines collectively carried 550,800 passengers, 68 percent more than their Chinese counterparts. The consolidator FedEx reported \$442 million profits in 1999 with an average cargo load factor of 64.2 percent on all its international flights in 1998 (Meyer, 2002). In the Sino-US market, the three US airlines¹⁴ shipped a total of 27,400 tonnes of cargo, though only 44 percent of the total market. Figure 6.11 shows the performance of the 6 designated carriers in Sino-US market in 1998.

¹⁴ FedEx replaced Evergreen International in 1993.

Figure 6.11 The performance of the 6 designated carriers in Sino-US market in 1998.



Source: www.caac.gov.cn

6.5.3.5 The agreement reached in 1995

The meeting in 1995 led to a protocol signed between the two parties, which allowed the designated carriers to enter into code-share arrangements to facilitate passenger travel. The key points are summarised as follows:

- A third combination carrier for China would be allowed due to the absence of an all-cargo operator as well as one more gateway city in the US with full traffic rights for all Chinese carriers;
- An increase of weekly frequency from two to four was agreed for the US' cargo operator; and
- Codeshare arrangements between the designated carriers were encouraged.

The amendments enabled China Southern to become the third Chinese combination carrier which selected Los Angeles as its first US destination and FedEx to increase its operations to four weekly frequencies. The amendments also allowed direct services without any stopovers, such as at Tokyo, between the two countries, resulting in Northwest launching a direct Detroit-Beijing service later in 1996. The carrier deliberately chose NW88 as its flight number in order to attract Chinese passengers, who culturally believe that the number 8 would bring great fortune and good luck to one's life. The reduced flight hours (from 15 hours via Tokyo to 9 hours) by flying across the Arctic above Russia boosted the enthusiasm of Chinese passengers to visit the US, who were convinced that the US was not that far away at all.

Benefiting from the phenomenal growth in bilateral trade and passenger traffic, carriers of both sides reported a shortage of capacity by the end of 1998 when both sides had used up their entitlement of 27 weekly frequencies. To facilitate the airlines to meet the market demand, the two parties sat together in April 1999, which resulted in a protocol that considerably relaxed the restrictions on operations.

6.5.3.6 Expectations of both sides before 1999 and the arrangements reached

Encouraged by its achievements in Open Skies arrangements with five Asian economies as well as those in other continents, the US government had a high expectation out of the consultation with China (Meyer, 2002), with the hope of removing barriers for the ambitious airlines such as Delta, American, Polar Air Cargo and UPS to enter into Asian markets, with China being one of their key targets. In contrast, the Chinese side was not enthusiastic about opening up further its air travel market for free competition, given its loss-making airlines and embarrassing safety record over the last decade (Meyer, 2002).

The divergent expectations did not prevent both parties from reaching an agreement despite the negotiations being tough. The protocol concluded was considered the greatest step forward toward liberalization of Sino-US aviation trade since 1980 (Meyer, 2002). It authorized a fourth carrier from each side to enter the market beginning in April 2001 and another 27 frequencies (totalling 54 for each side representing a 13.5 fold increase compared with the 4 weekly frequencies of 1980 or twice as many as that

agreed in 1995) through phased-in arrangements. It also granted the airlines the freedom to originate their combination services (on Routes A and B) from any city of their choice in their respective home countries and land at a few more destination cities in the other party's home country, bringing the total number of gateway cities in the US served by the Chinese carriers to 12 and that in China to 5. Table 6.5 summarises the amendments reached in 1999 compared with the agreement of 1980.

Table 6.5 Summary of the 1999 agreement and the comparison with 1980.

Item	Contents	Compared with 1980
Routes A and B for both sides	5 gateway cities in China, 12 in the US	2 in China, 5 in the US
Route C/Cargo route	No limitations in terms of airports to be served in the other party	No dedicated cargo routes available
Number of designated carriers for each side	4	2
Weekly frequencies for each side	54	4
Codeshare arrangements	Yes	Not permitted

Source: adapted from the 1980 and 1999 amendments

6.5.3.7 Implementation of the protocol and reaction of the industry

Again, the amended agreement could not satisfy the needs of the major US carriers who applied for US-China traffic rights. The incumbents such as United and Northwest wanted additional operations to achieve economies of scale while the prospective entrants wanted the opportunity for new ventures. For example, Delta lobbied for a daily non-stop service between New York and Beijing (Meyer, 2002), while American wanted to launch a brand new service out of its Chicago hub so as to allow it to create

links for some eighty US communities to China. It argued that the services could cover both passenger and cargo operations which would help enhance social as well as economic ties between the two societies (Beane, 2007). Polar Air Cargo and UPS both requested all-cargo services to China, claiming that such provisions would help greatly improve the employment of US industries (Beane, 2007). Eventually, the DOT chose UPS as the designated fourth carrier in the US-China market, largely due to the strong support from more than 350 members of Congress, various state governors and the intense lobbying of the Teamsters union (Beane, 2007). A six weekly all-cargo service was launched in April 2001, thus ending FedEx's monopoly in the Sino-US cargo market (Beane, 2007). The DOT also split the remaining slots between the incumbents including Northwest, United and FedEx, enabling them to provide more frequent services between the two countries.

Contrary to the fierce competition for traffic rights among US carriers, the Chinese side went through a quiet process in introducing CCA, an all cargo operator affiliated to China Eastern, to the Sino-US market as the fourth carrier. This was understandable since there were no other carriers existing in the market that were licensed by the Chinese authority to operate long-haul international routes. The incumbents such as Air China remained eligible for all-cargo operations under its capacity entitlement, while China Eastern and China Southern were able to carry cargo on their passenger aircraft.

Although codeshare arrangements were agreed and encouraged in 1992's amendments, regrettably, none was concluded between the designated carriers. One of the reasons was that neither the Chinese government nor the Chinese carriers were prepared to discuss any codeshare arrangements as they did not feel comfortable nor confident about this kind of commercial deal since they were uncertain of what codeshare meant and what the outcome would be for them.

In the following years, active actions were taken to address the concerns. Analytical commentaries were published in industry journals to explain what codeshare was. US solicitors and aviation consultants were invited to give lectures on how codeshare would work with the benefits and pitfalls being elaborated. Eventually, almost six years after the initial introduction of the codeshare concept, the Chinese side was prepared to

negotiate codeshare deals with their US counterparts, leading to agreements reached between almost all designated carriers in 1998. Northwest agreed a wide range of code-share arrangements with Air China, which gradually developed into an exclusive cooperation between them, China Eastern code shared with American and China Southern collaborated with Delta.

6.5.4 A milestone protocol reached in 2004

6.5.4.1 The US's China policy

When George W. Bush took over the presidency from Clinton, he, in the early days, repeated what Clinton did by breaking with Republican tradition to take China as a strategic competitor. Soon afterwards, Bush changed his tone from one of “containing them” to “engaging a friend”, shifting his China policy to allies after the 911 event. Over the following years, Bush’s China policy was viewed as one rare bright spot in the 21st century featuring both unprecedented bilateral cooperation on shared concerns, such as terrorism, the global financial crisis, and economic issues such as trade imbalances, as well as competition for regional influence (Shi, 2009). China’s accession to the WTO helped involve the country in a web of interdependence with the rest of the world, in particular with the US, with whom its trade reaching \$11.89 billion in 2001, a 27.2 percent increase year on year (www.mofcom.gov.cn). On the other hand, China’s continuous export growth to the US brought the US trade deficit to a new level, with antagonism towards China flaring in the US (Lynch, 2005). Sino-US Strategic Economic Dialogue (SED) aimed at maintaining a direct communication at the senior level and US-China Aviation Cooperation Program (ACP) aimed at promoting technical, policy and commercial cooperation between the aviation sectors of the two countries were launched in 2004, which produced positive effect on aviation with closer links and exchange activities.

6.5.4.2 China's US policy

From the late 1990s after the Kosovo War China gradually changed its perception of multipolarity, being convinced that the US remains as the sole power of the international system, which would still pose a threat to China’s security (He, 2009).

China adjusted its US policy by choosing to be accommodating and not confrontational, stating that the military gap between the US and all other powers remained constant and was expanding such that the US-led unipolar world would remain dominant instead of declining (He, 2009). Being quick and flexible in dealing with conflicts with the US, China manages to maintain a good relationship, with economic development and trade promotion being considered as the best strategy to deal with the US. In October 2002 during Jiang's working visit to the US, both parties recognized that China and the US should improve the bilateral dialogue and coordination on important international issues and to expand the cooperation in all areas so as to strengthen further the constructive working relationship.

Hu and Wen's Administration after 2003 has followed the same strategy towards the US, although at the same time China has reinforced its relations with its peripheral states, those in Africa, South America and the Middle East. China believes that peripheral states should take priority in its diplomacy despite big countries still being the key targets. The US is critical for China's peaceful rising and a strategic and constructive relationship should be maintained based on mutual benefits.

To implement the strategy, in December 2003 soon after Hu and Wen took office, Premier Wen proposed 5 principles with respect to the development of Sino-US fair trade and economic cooperation, which included:

- a. Creating a win-win situation for mutual benefit;
- b. Taking development as a priority to resolve any disputes through economic and trade cooperation;
- c. Optimizing the collaboration mechanism for timely and effective communication and discussion;
- d. Coordinating and discussing fairly to seek for common ground; and
- e. Not politicalising economic and trade issues.

To ensure that China has a bigger role to play in managing the Sino-US relation, Chinese President Hu Jintao in April 2006, when launching the SED, further elaborated a 6-points proposition, three of which were:

- a. Improving mutual understanding to enlarge the common ground so as to develop a long-term, stable, constructive and cooperative relationship;
- b. Seeking for opportunities to strengthen the bilateral economic and trade cooperation;
- c. Respecting each other, appreciating and addressing properly the differences.

With the above doctrines as guidelines, China has pursued its US policy in a wider context, especially in the realm of trade and economic development, including currency stability, energy sufficiency and the projection of Chinese “soft power”.

In terms of air transport, the US “Open Skies” policy had become widely accepted with around 90 nations accepting such agreements with the US during Bush’s tenure. The US also concluded with the EU the first stage Open Skies deal in 2007, which served as a model for other country-pair negotiations. For US-China market, the 2004 protocol was widely regarded as a landmark in removing the economic restrictions constraining the commercial operations of air transport between the two nations.

6.5.4.3 Market development between 1999 and 2004

The years following the 1999 Protocol retained the momentum of continuous growth of trade and traffic between the two countries with 2001 marking a historical milestone when China gained WTO access. China attracted over \$100 billion investment from the US in 2003 involving more than 40,000 projects and more than 180,000 Chinese students studying in the US. Travel in both directions increased by an average of 12 percent over the four years, with American arrivals in China increasing by 15 percent while Chinese visitors to the US rose by 8 percent. However, the 911 terrorist attack had a severe impact on air travel which resulted in the tight control of US visas and stringent security measures, causing a drop of 5.7 percent in 2002 of Chinese tourists heading for the US. Before the market was hardly able to recover, SARS in 2003 caused another loss of passenger traffic which resulted in a 27 percent decrease for the first seven months of 2003.

Nevertheless, the 1999 amendments created a framework for airlines to meet the market demand. The US carriers were quick in taking actions to capitalize in the market.

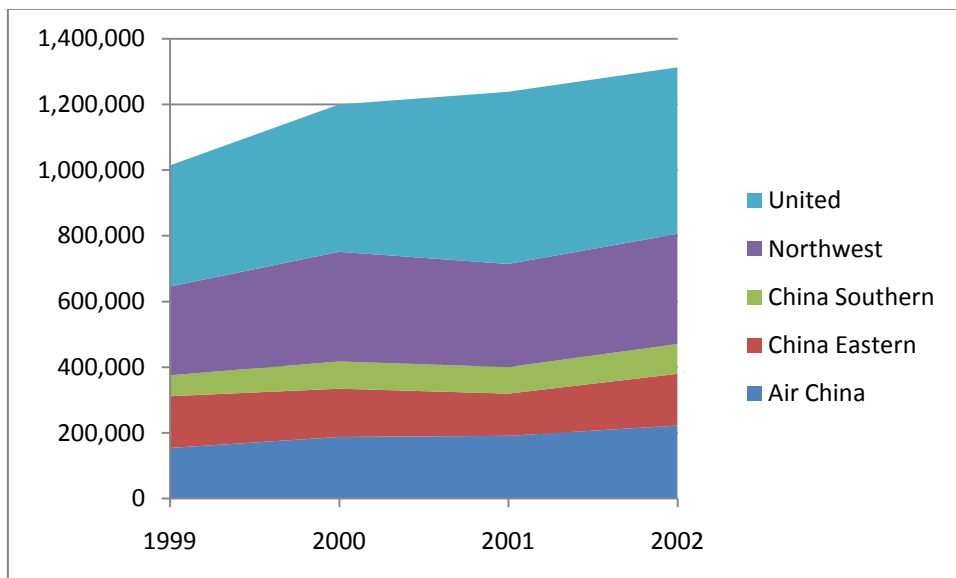
Northwest Airlines launched its twice-weekly Detroit-Shanghai service in the spring season of 2000 and achieved an average 85 percent load factor for the first few months, contributing to its extraordinary performance in the Asia Pacific region, where nearly 23 billion RPM was generated during 2000 (Meyer, 2002). United reported a similar outstanding performance in the region with an average 70.8 percent load factor producing 11.5 billion RPM for the first six months of 2000. As the market continued booming, the four US carriers, namely United, Northwest, FedEx and UPS, soon found themselves restrained by the capacity restrictions for further expansion in the market, as they had collectively used up all the 54 weekly frequency entitlements in 2001, which was only more than one year after the 1999 amendments. Finding themselves in a constrained circumstance, carriers such as Northwest went to their Chinese counterparts for help in an attempt to conclude any kind of commercial arrangements so as to allow the carrier to virtually expand their operations into China, though their efforts did not bring any outcome.

The devastation of 911 resulted in US airlines making a significant loss, leaving quite a few major carriers such as United and Delta to seek Chapter 11 bankruptcy protection. Facing with the sluggish domestic market, the US carriers recognized that great opportunities existed in international markets which would help compensate for their loss. A well noted trend had been that the major US carriers have deliberately focused their route planning efforts on more profitable international routes, such as Asia Pacific, Commonwealth of Independent States and Middle East, which produce higher yields (Compart, 2005). For example, United reduced its capacity in the North American market by nearly 14 percent between Aug 2004 and Aug 2005 but at the same time increased its operations to China by adding more frequencies and destinations, leading to the carrier to gain a bigger market share in passenger traffic, rising from around 25 percent in 2000 to 49 percent in 2005, almost half of the total market (www.caac.gov.cn).

In contrast to the speedy expansion of the US carriers, the four Chinese carriers, namely Air China, China Eastern, China Southern and CCA, were quite cautious in increasing capacity and destinations compared with their US counterparts. Air China managed to launch a thrice weekly non-stop service between New York and Beijing in September

2002 and a twice weekly cargo service between Beijing, Oregon and Portland in October 2002 while China Southern started thrice weekly cargo flights between Guangzhou and Los Angeles at the same time (Meyer, 2002). One of the reasons for the reluctant reaction was that Chinese carriers found it difficult to make money from the international operations compared with their lucrative domestic market where a high demand has remained for decades. Data available showed that all Chinese carriers were only able to produce approximately 10.3 billion RPK collectively in 2000, less than half of that generated by Northwest's operations in the Asia Pacific region for the same period (Meyer, 2002). In 2001, the three flagship carriers made a total loss of less than \$10 million, resulting in them to be more cautious in increasing capacity. The slow implementation did not bring the total frequencies of Chinese carriers to its full entitlements. By the Summer/Autumn season of 2003, the Chinese passenger carriers had only used up 44 weekly frequencies, 81 percent of their total entitlements. Figure 6.12 is the split of passenger traffic between the two countries from 1999 to 2002, which demonstrates that US carriers were carrying more traffic than their Chinese counterparts.

Figure 6.12 Passenger traffic between the two countries from 1999 to 2002

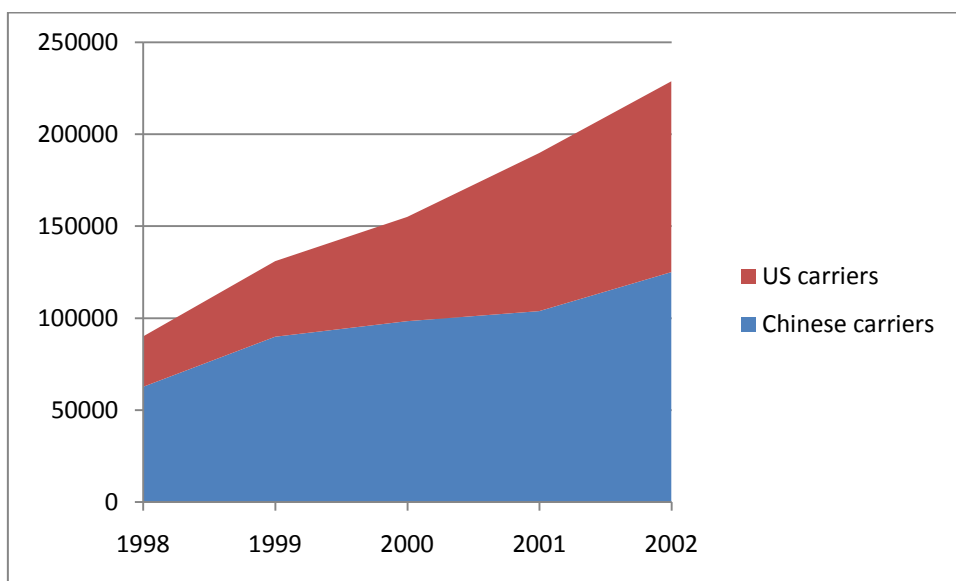


Source: www.caac.gov.cn

In addition to the scheduled services, carriers of both sides also requested additional services to meet the special demands in certain periods of the year. According to the statistics of the Chinese authority, in 2003, 114 additional frequencies were flown by US carriers to Chinese destinations representing 2.2 more frequencies per week and a total of 94 extra flights were operated by Chinese airlines to US destinations, indicating 1.8 more weekly frequencies.

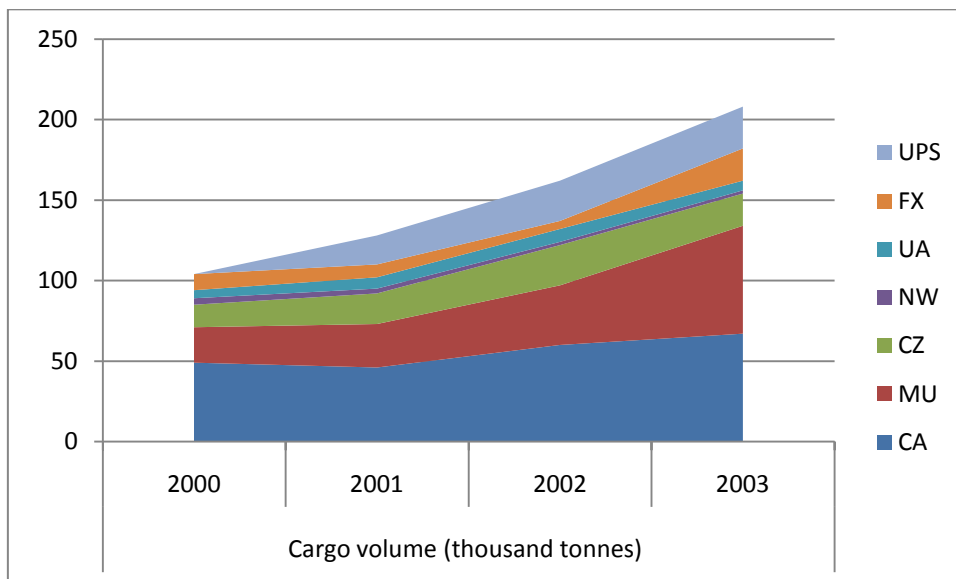
Contrasting to the passenger market, where the US carriers were so keen and able to capitalise while the Chinese were reluctant and passive in competing, the air cargo market was another scene. Airlines of both sides were not only eager to increase frequencies but also proactively competing with each other for a bigger market shares. This was reflected in the operational volume as well as the load factors. As a result of the continuous booming of bilateral trade, the total volume of air cargo between the two countries increased to 229,000 tonnes in 2002 from 90,000 tonnes in 1998, representing a 26.7 percent increase year on year (Figure 6.13). When examining the performance of each carrier, the statistics available shows that UPS and China Eastern were able to gain an increasingly bigger market share while Air China's dominant position was dismantled (Figure 6.14).

Figure 6.13 Air cargo volumes between 1998 and 2002.



Source: www.caac.gov.cn

Figure 6.14 Split of air freight carried by the designated carriers between 2001 and 2003.



Source: www.caac.gov.cn

6.5.4.4 Carriers of third countries competing in the China-US market

Since the beginning of the 21st century, the Sino-US market has become the most lucrative. While the US carriers were restrained from expanding capacity to capture the market demand as a consequence of the regulatory controls in place and with the Chinese carriers failing to utilize their full entitlements leaving a handful of weekly frequencies unused, airlines from third countries rushed in to grab the opportunity. Taking advantages of their liberalized arrangements with both China and the US, these third country carriers were able to penetrate for a share of the big cake. Statistics showed that only 40 percent of the freight between China and the US was shipped by the designated carriers of both sides while the majority was actually taken by third countries airlines utilizing the 5th or 6th traffic rights between China, the US and their home countries as well as those non-designated US carriers such as Evergreen International and Polar Air Cargo that were authorized to fly to adjacent destinations such as Hong Kong, Tokyo and Seoul (Civil Aviation University of China, 2006). For example, Singapore Airlines operated 4 weekly services to Anchorage, Chicago and Los Angeles via Nanjing and Xiamen in China with the 5th traffic rights. Korean Air and

Japan Airlines Cargo operated between China and the US via Seoul and Tokyo by using the 6th traffic rights.

The significant leakage of cargo not only caused the loss of revenues for designated carriers but also adversely helped those third country airports to develop into hubs to compete against Beijing, Shanghai, and Guangzhou, which are China's biggest three airports that have been also ambitious to develop into hubs in Asia. Table 6.6 summarises the carriers and their total cargo capacity operating between China and the US in the summer season of 2003, which indicated that the arrangements between China and the US reached in 1999 were no longer able to satisfy the market demand, which necessitated the urgent need to increase the direct services and capacity.

Table 6.6 Cargo carriers competing in the Sino-US market (summer season in 2003).

Airports	Carriers operating at the airport	Weekly frequency in total	Destinations in the US
Hong Kong	Northwest Polar Air Cargo FedEx Evergreen International Cathay Pacific Japan Airlines Cargo	68	Anchorage New York Chicago Los Angeles
Seoul	Korean Air Cargo Asiana Airlines Northwest Polar Air Cargo	97	Los Angeles, New York Chicago San Francisco

	FedEx UPS		
Tokyo	Northwest Japan Airlines Cargo Japan Airlines Lufthansa Polar Air Cargo	50	Anchorage New York Los Angeles Chicago
Beijing Shanghai Shenzhen	Air China (Cargo) China Cargo China Southern	19 (respectively)	New York Los Angeles Portland Chicago
Beijing Shanghai	FedEx UPS Northwest	20 (respectively)	Memphis Anchorage New York Dallas
Nanjing Xiamen	Singapore Airlines	4 (respectively)	Anchorage Chicago Los Angeles

Source: compiled by the author from various sources

6.5.4.5 Preparation by both sides

The above situation was brought into attention of the respective governments, which realized the need for urgent actions. The two agreed to resume discussions in late 2003. By the end of 2003, the US had concluded 59 Open Skies with its partners, almost twice as many as it had in 1998 (31 Open Skies by the end of 1998). Among them, 10 were Asian economies including Taiwan, Singapore, Malaysia, Brunei, New Zealand, Pakistan, Uzbekistan and South Korea. These Open Skies deals had significantly facilitated the US carriers to develop their networks in the Asia Pacific region, thus strengthening their market leader position on a global scale. The US was convinced that it was the right time for China to lift the market entry barriers to enable free competition since it had been three years with the WTO.

In terms of the Sino-US market, as China's overall trade volume was projected to increase substantially in the coming years, the aviation sector would be expected to play a vital role in the evolving Sino-American trade relationship. A DoT study had shown that air freight had been the fastest growing segment of the US cargo industry, hence, the expanding aviation opportunities between the two nations would mean that more US airlines, businesses and travellers could take advantage of the growing trade between the two rapidly expanding economies (www.hktdc.com). The Chinese market would represent the real long-term opportunity for the US airline industry and Open Skies with China would allow the US carriers to further capitalize in the market. With the above objectives in mind, the US side wanted to achieve the following:

- To increase the number of designated carriers for passenger operations;
- To separate the passenger capacity from the cargo so as to allow unrestricted cargo operations;
- To allow codeshare arrangements in a third country;
- To allow the US carriers to set up operational hubs in China and change aircraft type enroute of a flight; and
- To allow the US carriers to do self ground handling and set up offline offices

Acknowledging the “wants” of the US side, the Chinese government had its own considerations. CAAC wanted to open up the Central, Western and Northeastern regions of the country to support the central Government’s call for “Western Development” and “Northeast Regeneration” campaigns. CAAC was also in a position to consider the opening up of cargo operations in order to support the national strategy of an “export-oriented economy”. At the same time, CAAC recognized its obligation to remove market entry barriers to comply with the WTO commitment. However, as to how to remove these barriers, CAAC seemed to have no specific strategies and tactics, nor any contingency measures in place to safeguard the operations of its carriers.

In taking soundings from airlines and airports, CAAC received completely different views. Shanghai Airlines and Hainan Airlines wanted to become new entrants to the market, pointing out that the current Chinese incumbents had failed to utilize all the capacity entitlements, which was truly a waste of resources. Guangzhou airport would welcome as many as possible new direct flights to the US in order to support its hub strategy to compete with Hong Kong and to facilitate the local economic growth. Hainan Provincial government requested the island be granted full 3rd, 4th and 5th freedom traffic rights on the Sino-US markets so as to facilitate the development of the tourism industry of the island.

Contrary to the positive views expressed by the prospective entrants, the incumbents such as Air China, China Eastern, China Southern and China Cargo strongly opposed to any increase of the numbers of designated carriers and capacity, nor did they agree to the codeshare arrangements with a third country carrier. They argued that their international long-haul operations, especially to the US, were loss-making services inclined to be affected by any external occurrences, such as the 911 terrorist attacks, SARS and the US visa and security controls. They were disadvantaged in winning passengers, in particular the high-yield business travellers, due to the stringent visa regime imposed by the US government for foreigners. They demanded a practical mechanism to be in place before any increase of numbers of designated carriers and capacity to be agreed and to address the US visa issue which constrained demand of Chinese passengers travelling to the US. Codeshare arrangements in a third country should not be agreed either. They pointed out that such an arrangement would only

allow the US carriers to develop new hubs in the region, such as South Korea, to strengthen their operations in the East Asian region, thus only benefiting the US carriers who had used up their capacity entitlements in the market.

6.5.4.6 Protocol agreed

With different objectives on the agenda, several rounds of discussions were conducted. In June 2004, the two delegations met for the fourth time in Washington with the aim of striking a deal. The US delegation was headed by Marianne Myles, its Director of Office of Aviation Negotiation in the DoS and was composed of 38 members including officials from the DoS and DoT, as well as representatives from airlines, airports and industry associations. The Chinese delegation was led by Wang Ronghua, Director General of the Department of International Affairs & Cooperation of CAAC and was comprised of 26 members including officials from CAAC and representatives from airlines.

After several days of tough negotiations, a protocol was eventually agreed with the following key points being agreed:

- To increase the number of designated carriers from 4 to 9 by 2010;
- To increase the capacity from 54 to a total of 249 flights¹⁵ weekly for each side by 2010 through a phased-in arrangement (a total of additional 195 weekly flights for each side, with 111 by all-cargo carriers and 84 by passenger airlines). 14 weekly frequencies would become available for new US passenger services as of 1st August 2004. Of the 249 frequencies, up to 133 could be introduced

¹⁵China has divided its aviation market into three zones: Zone One include airports of Beijing, Shanghai and Guangzhou; Zone Two included airports in Eastern and coastal cities such as Nanjing and Hangzhou; while Zone Three refer to the rest provinces in Central, Western and Northeastern China such as Henan, Anhui, Hubei, Hunan, Jiangxi, Guangxi, Guizhou, Yunnan, Sichuan, Chongqing, Shaanxi, Shanxi, Gansu, Ningxia, Qinghai, Tibet, Xinjing , Heilongjiang, Inner Mongolia, Jilin, Liaoning and Hainan Island.

The 249 flights involved cities in Zones One and Two only. For Zone Three, there is no limitation for any operations.

before 2007.

- To open up cargo operations and to allow US carriers to set up cargo hubs in Chinese territory;
- To allow both domestic and third country codeshare arrangements between the designated carriers of both parties;
- To relax restrictions on commercial activities in a staged manner, including the setting up of offline offices, change of gauge and self ground handling, etc.

Source: Adapted from the 2004 Protocol

The Protocol was recorded as a first timer in several ways:

- a) It was the first comprehensive amendment of its kind to date which radically liberalised the original ASA signed in 1980 in terms of market entry, cargo operations, codeshare arrangements, ground handling and offline services;
- b) It was the first time in China's aviation history that foreign carriers were allowed to operate to any destinations in the Western, Northern regions and Hainan Island without any restrictions in frequency, though a few cities such as Urumqi, Xi'an, Chengdu and Chongqing had been open for limited international operations for quite some time;
- c) It was the first time that foreign carriers were allowed to set up a cargo operational hub with full traffic rights in the territory of China. In addition, it permitted a nearly five-fold increase in capacity over the next six years and agreed that pricing for both passenger and cargo operations could be decided by market forces. The Protocol also outlined a timescale for further discussions which would be held in 2006 so as to review the implementation and consider the next steps of opening up the market.

6.5.4.7 Reaction of stakeholders and implementation of the Protocol

The Protocol was lauded widely by the international aviation community, especially by the US government and industry for effectively creating a regional Open Skies within China (Beane, 2007). With an estimate of \$12 billion additional revenues for US carriers over the next seven years (<http://usinfo.state.gov>), the Protocol was welcomed as a milestone by the US DoS with Colin Powell making a supportive announcement. It

demonstrated that the commitment of the US government to Sino-US economic relations had brought substantial consequences and would bring benefits to US industry, entrepreneurs and consumers. Norman Mineta, the then Secretary of the DoT, claimed that the agreement recognised the key role played by commercial aviation in Sino-US bilateral trade relations and was a landmark in establishing an international air transport system that would satisfy the needs of the global market.

The liberal arrangements enabled the US DoT to grant most applications from its major passenger carriers to fly or increase capacity to China, though competition for the 111 cargo flights was extremely intense (www.english.caijing.com.cn). For instance, United applied for a direct service between Chicago and Shanghai and Northwest intended to launch a Detroit-Guangzhou service with a stopover in Tokyo where its Asian hub is located. Delta, American, and Continental were all satisfied as newly designated carriers though two low-fare carriers Hawaiian Airlines and North American Airlines also applied for traffic rights without success. To make sure that their applications were granted, both American and Delta had set up specific websites where people could log on to support the bids for their China routes by sending messages directly to the DoT (Beane, 2007). The campaign proved to be very successful. American was able to cite the support of 26 senators, 78 house representatives, 7 governors, 24 mayors and 38 airports in favour of their Dallas-Beijing application while Delta and Continental were able to generate more than 10,000 employee letters to back their China services.

Competition for the right of cargo operations was fiercer than for passenger services. The DoT revealed that it had received more than 200 applications for new flights to China (Beane, 2007). UPS planned to add six more cargo flights to China while FedEx wanted to set up a cargo hub in Guangzhou. Polar Air Cargo would like to launch a new all-cargo service to China too. Thanks to the big expansion of designated carriers and capacity, all requests from carriers were satisfied.

Unlike the overwhelming endorsement gained from the US side, the Chinese reaction was a mix of joy and dissatisfaction. CAAC was pleased to see that it was able to address the imbalance of the market operations in such a way as to satisfy the market demand through proactive discussions with its counterpart and come to an agreement. In

so doing, CAAC was able to meet the trends of the all-embracing opening up of the country to global markets with an innovative approach, hence enhancing the bilateral economic relationship between the two countries to a higher level. With the mounting pressure from local Chinese municipal governments (www.english.caijing.com.cn), CAAC was able to support local economic growth by allowing the establishment of the direct air links with the US, one of China's top export destinations, and to encourage and retain foreign direct investment to central and western China (www.english.caijing.com.cn).

Some Chinese carriers welcomed the relaxed arrangements. Shanghai International Cargo, Yangtze Express and Hainan Airline were pleased with the Protocol as they were granted Sino-US route licences without much opposition from their peers. They soon launched their cargo services to Dallas and Portland, thus, increasing Chinese carriers' cargo destinations in the US territory in addition to the airports at Anchorage, New York, Chicago, Los Angeles, San Francisco and Seattle.

The Chinese incumbents responded with anger, panic and nervousness. They bitterly criticized CAAC for being unable to protect them effectively by not giving adequate attention to accommodate their needs. They claimed that their views were not taken into account responsibly, nor were their comments on the US proposals considered properly. Their suggestions and counterproposals were just ignored. They not only had no plans to launch any new or additional flights but were extremely concerned about the viability of their existing services. With such a relaxed arrangement with the most competitive aviation country in the world, they were worried if they were capable of competing with their US rivals, taking into account their current fleets, their scale of operations and their high operating costs. Of the 54 weekly flights allowed under the 1999 agreement, Chinese carriers had only run 48 before the 2004 negotiations. Air China operated 22 of the flights. China Southern and China Eastern each ran 7 US-bound flights, and China Cargo Airlines operated the remaining 12. With 249 frequencies, what would they do with this 4.6 fold increase in capacity? "In terms of cargo, China has less than 20 aircraft that can handle trans-Pacific routes," noted one senior industry executive, "how can we compete against America, which has more than 1,000 such planes (www.english.caijing.com.cn)?"

The 2004 Protocol had a far reaching impact on the air transport market for China's peripheral neighbours. Korea and Singapore reacted by assessing the impact that this arrangement would bring to their carriers, while the Taiwan authority urgently advocated a direct link across the straits so as to dilute the adverse impact on its market as a result of the new arrangements.

6.5.5 The latest round of consultation in 2007

The continuous growth in bilateral trade generated a phenomenal increase in both passenger and cargo traffic. The expanded arrangements in 2004 provided opportunities for carriers to capture the market demand. Immediately after the consultation, the 6¹⁶ US carriers including the 3 that were just recently received traffic rights launched a total of 78 new flights (29 passenger and 49 cargo services). By the winter season of 2005/2006, the 7 US carriers were operating 114 weekly frequencies with a split of 56 passenger flights and 58 cargo operations. One year later in 2006, the 7 US carriers were flying 132 weekly services with 63 passenger and 69 cargo flights, representing 99 percent utilization of their full weekly entitlements (133 weekly frequencies) to the traffic rights.

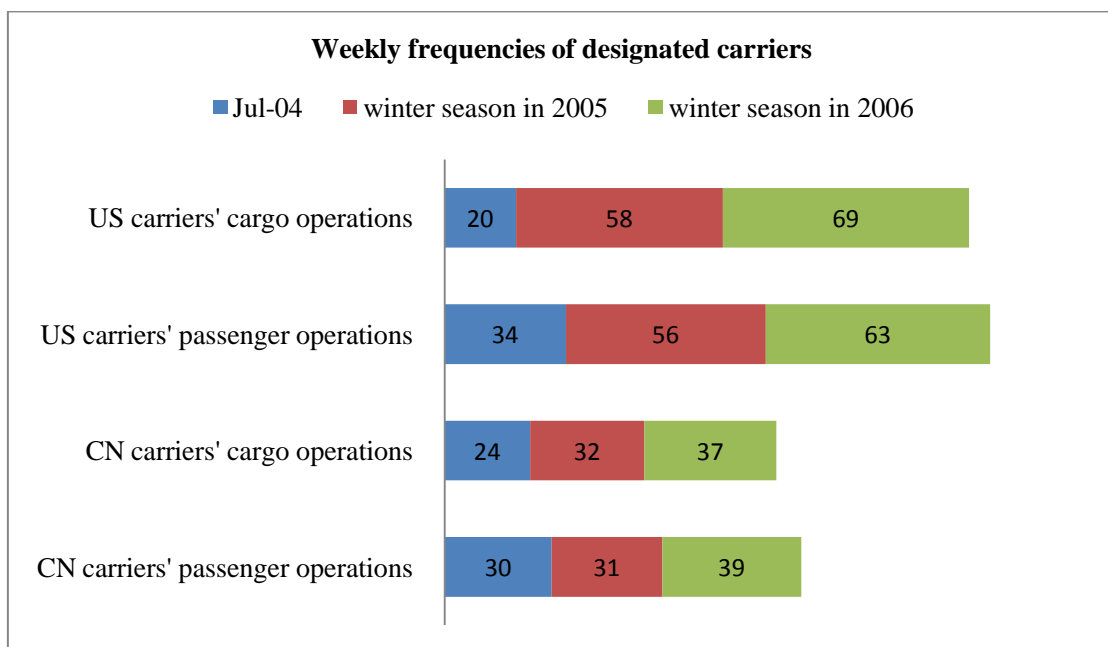
Contrasting with the proactive and aggressive action of the US airlines, the Chinese carriers were conservative in implementing the Protocol. Although both Shanghai Airline and Yangtze River Express were awarded the traffic rights, neither of them launched any services until July 2006, almost two years after the conclusions of the Protocols. In the winter season of 2005/2006, the 4 Chinese incumbents were operating a total of 63 weekly frequencies with 31 passenger and 32 cargo services. Nevertheless, the Chinese incumbents managed an additional 7 frequencies in the Sino-US markets after 2005, with Air China¹⁷ starting 3 weekly Beijing-Los Angeles services and 3 weekly Beijing-New York services, and China Southern providing an additional 2 weekly Guangzhou-Los Angeles flights. In terms of cargo operations, the Chinese incumbents only increased 4 frequencies after the 2004 Protocol compared with the 49 new cargo services by the US side, which was less than one twelfth. As Air China

¹⁶ Except American Airlines which did not launch their service until 2006.

¹⁷ Air China reduced one weekly frequency on Beijing-San Francisco.

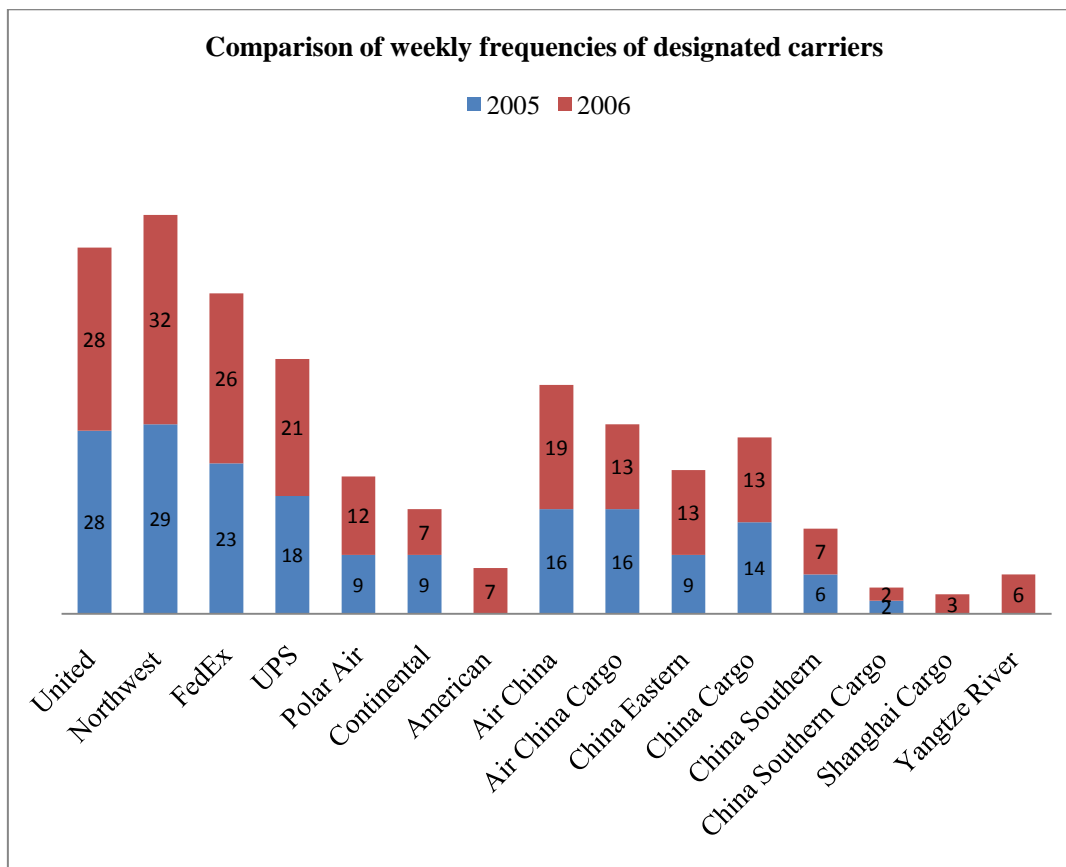
separated its cargo operations from the passenger business, Air China Cargo became independent and obtained a separate route licence from both CAAC and the US DoT for the Sino-US market and launched a thrice weekly all-cargo service on its existing routes. The other new service was added by China Cargo which only managed to increase just one frequency per week. By the winter season of 2006/2007, the 7 Chinese carriers only operated a total of 76 weekly frequencies with 39 passenger and 37 cargo services, representing 57 percent of utilization of their entitlements of weekly frequencies (Figure 6.15 and 6.16).

Figure 6.15 Weekly frequencies of designated carriers of both sides from July 2004 to the winter season of 2006/2007.



Source: www.caac.gov.cn

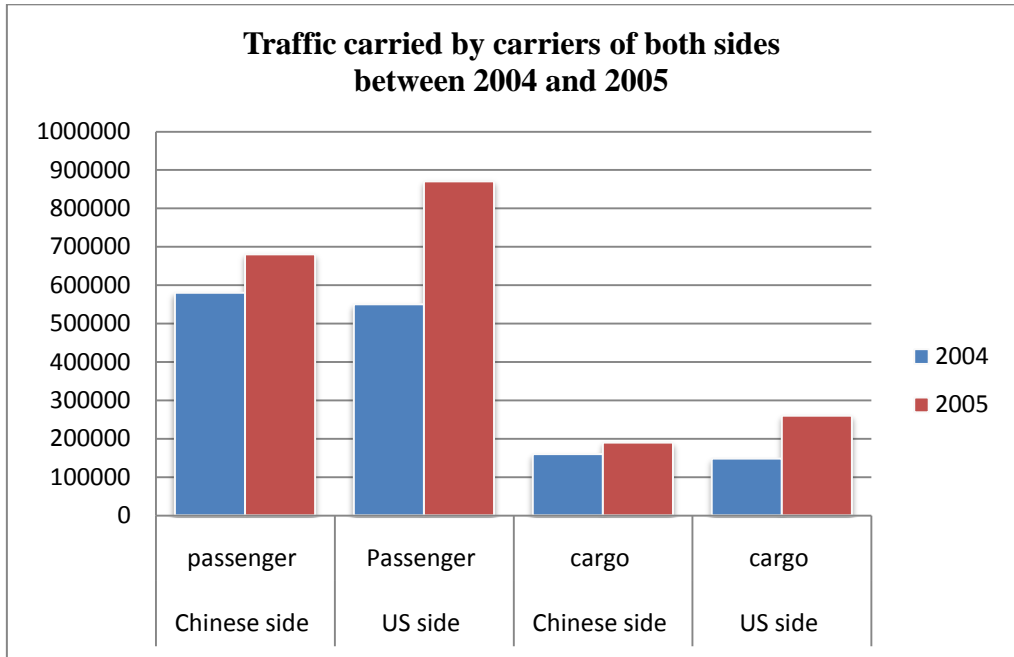
Figure 6.16 Comparison of weekly frequencies of the designated carriers operating in 2005 and 2006.



Source: www.caac.gov.cn

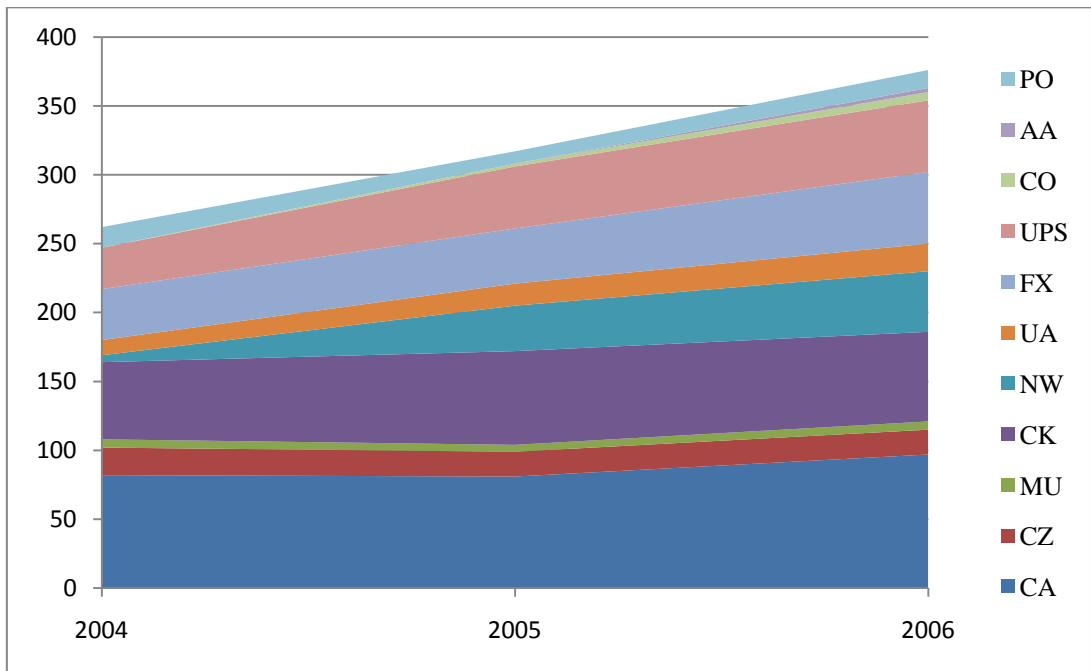
The weekly frequencies operated reflected the performance of the carriers. In 2004, 1.13 million passengers were carried in both directions by the designated carriers with the Chinese side capturing 580,000 taking 51 percent market share. In 2005, the Chinese side carried 680,000 passengers of the total 1.55 million, with their market share dropping to 43.8 percent. In terms of cargo traffic, in 2004, of the total 308,000 tonnes of air freight carried by all the designated carriers, 51.9 percent was carried by Chinese airlines. In 2005, of the total 450,000 tonnes of cargo, only 42 percent (190,000 tonnes) was carried by the Chinese side, with their market share reducing almost 10 percent (Figure 6.17). An examination of the performance of individual carriers revealed that Northwest experienced the biggest increase of market share while the Chinese carriers remaining flat (Figure 6.18).

Figure 6.17 Traffic carried by carriers between the two countries from 2004 to 2005.



Source: www.caac.gov.cn

Figure 6.18 Cargo volumes carried by individual designated carriers between 2004 and 2006 (in thousand tonnes).



6.5.5.1 Preparations for the negotiations by both sides

The sharp contrast of performances as a result of implementing the 2004 Protocol came to the attention of both authorities, which decided to sit together in April 2006, one year earlier than what was committed to in the 2004 Protocol, to review market conditions and discuss the possibilities of further removal of the restrictions on operations between the two parties.

The US wanted to keep the momentum achieved in 2004, aiming at achieving a full Open Skies arrangement with China, being convinced that a relaxed operational environment would bring benefits to both airlines and customers, as demonstrated by the outstanding performance from implementing the 2004 Protocol. By this time, the US was more comfortable in dealing with Asian countries after having successfully concluded 70 Open Skies deals with its global partners by the end of 2005 with a few more Asian countries being added to the list including Indonesia, India and Thailand. It believed that it could achieve its ultimate objective by pushing hard with China. Furthermore, the US held that a more liberalized arrangement of air transport between the two countries would not only help its carriers to expand into the Asia/China market, where they had been getting a better position to compete, but also support the export of US high technology and the goods of high value to China and help to resolve the imbalance of bilateral trade, of which the US was in deficit. In addition, it would facilitate the flow of people who would in turn facilitate the promotion of the services industry between the two countries.

The US industry strongly backed its government's proposal. The 2004 Protocol provided great opportunities for them to capture more traffic with a growing market share and strong market presence. They put forward aggressive plans to expand their China operations which included increase of new designations and capacity, and removal of the restrictions on cargo operations and conditions attached to change of gauge. For example, Delta wanted to be a designated carrier in 2007 and launch services from Atlanta to Beijing and Shanghai while United wanted a Washington-Beijing service. American, Continental and FedEx all wanted to increase frequencies to Beijing,

Shanghai and Guangzhou. The US airports and local authorities also voiced their interest in having more direct flights to China, such as the Guam Islands which wanted to have as many as possible Chinese visitors to boost their tourism industry and local economic growth.

At this time, the Sino-US relations had been ushered into a new era. The two parties had declared a strategic partnership in 2006 with frequent exchange of visits of senior level officials. The SED was established in December 2006 with an aim of bringing together the very senior officials to one forum to discuss a wide range of topics including air transport relations. China had replaced Japan to become the US's second biggest trade partner in 2006, though the trade deficit had grown bigger.

In line with their overall objectives and taking into account the requests from the industry stakeholders, the US side was confident in the groundwork for a new agreement to be reached. "We want to reach a meaningful agreement about having full and open liberalisation of aviation. I believe we can reach such an agreement by May at the next SED event and hopefully implement the agreement at the end of the year", said Mary Peters, the US Transport Secretary, during her first visit to Beijing in April 2007 (www.payloadasia.com). At the least, the US was prepared to put the "basic framework" of an "Open Skies" agreement in place at this round of discussions so as to achieve a full range of Open Skies in March 2010. In order to ensure that Open Skies was achievable as planned, the US wanted to have a transitional arrangement that was able to pave way to the full liberalization of the bilateral market. To this effect, for the forthcoming negotiations, the US wanted to remove almost all the restrictions on the operations including the limits on the number of designations, weekly frequencies, charter operations, codeshare arrangements, cargo operations and other doing business matters though the model text of an Open Skies agreement could not prevail until March 2010. A specific time schedule was put forward for the Chinese side to agree in respect of removing the existing constraints. Specifically, the US intended to achieve the following:

- With respect to the number of designated carriers, the US was happy to see an unlimited designation of Chinese carriers with immediate effect and an unlimited

designation of US carriers effective as of March 2010. Before that, the US side wanted to have another carrier become eligible for operations starting from the summer season 2008.

- With respect to traffic rights and capacity, the US wanted to move Guangzhou from Zone 1 to Zone 2 and allow their airlines to operate as many flights as possible to Beijing, Shanghai and Guangzhou. They also wanted to have unlimited frequencies for cargo operations with immediate effect. To facilitate their operations, the US asked for the freedom of choosing one more intermediate point at its will for combination carriers.
- With respect to codeshare arrangements, the US wanted to have more airlines to be allowed to have codeshare arrangements in either country and remove the conditions attached to the third country codeshare arrangements. For charter operations, the US wanted to have a certain amount of charter flights to be approved over the next two years with the standard Open Skies text with respect to charter operations prevailing in 2010. To promote economic growth in Guam and the Northern Mariana Islands, the US welcomed carriers of both sides to start operations without any restrictions.

All in all, March 2010 should be the targeted time for the US and China to agree a truly Open Skies agreement with the standard Open Skies text applicable. Zone division in China with respect to the destinations of operations should no longer prevail, with the US carriers being allowed to operate from any points in their home country to any points in China with any frequencies.

Acknowledging such an aggressive proposal from the US side, China was not prepared to conclude anything that would be substantially different from what had been agreed in 2004. In China's view, it was not the right time yet for China to agree such a deal although it had taken a positive approach toward liberalization in international air transport, which the government believed that only a progressive and phased-in manner was appropriate. They were worried about the spill-over effects of such prospective "Open Skies" arrangements, which might inspire other countries and regions such as Singapore, Japan, South Korea and the EU to follow suit that are likely to show up the next day demanding "Open Skies" for their carriers (Wolf, 2007). Nevertheless, China

accepted the fact that the implementation of the 2004 Protocol had exerted a positive impact on the market. For example, the RPK of Sino-US traffic was up 72 percent in 2005 with Air China experiencing an increase of more than 12 percent in 2005 compared with 2004. The Protocol was considered positive in facilitating the hub strategy of Shanghai airport, which saw 96 weekly frequencies originating from the airport to US destinations and seats available being 1.77 times more in 2005 than that in 2004.

However, on the other hand, the Chinese authority was also concerned about the imbalanced market conditions. For example, the increase in passenger traffic mainly came from the US side while Chinese travellers to the US saw little increase over the last ten years. Although around 1.65 million passengers travelled between China and the US in 2006, a 25 percent increase over 2005, Chinese airlines were unable to capture half of the market. In addition, the Chinese were worried about the inadequate infrastructure capability at big airports such as Beijing and Shanghai as a result of the rapid growth of air transport, which were short of slots to accommodate more traffic.

When taking soundings from the industry stakeholders, contrasting views were expressed again. Airports like Guangzhou wanted to have as many as possible US bound direct flights, both passenger and cargo, to strengthen its hub status. The newly-setup all-cargo operators such as Jade Cargo¹⁸ and Great Wall expressed their strong wish to enter the Sino-US market. They argued that the Sino-US market was their priority for international operations and crucial in their network development. They would like to be designated sooner than later so as to allow them to take the opportunity of the continuous market growth.

Contrary to the ambitious start-ups, the Chinese incumbents reiterated their objection to a more liberalized arrangement opposing to any kind of increase in the number of designated carriers, frequencies, change of gauge and relaxed codeshare arrangements. They argued that they failed to move into the market as quickly as their US counterparts because they were short of long-haul aircraft and pilots, which were deployed in

¹⁸ Jade Cargo received the US DoT approval for an all-cargo charter operation in March 2007. The flight was changed to a scheduled operation after the 2007 agreement.

lucrative domestic markets. Statistics showed that the total number of long-haul aircraft of all Chinese carriers was only 41, less than 1/10th of the fleet of Continental Airlines which had 488 aircraft. The total number of cargo aircraft of all Chinese carriers was only 1/20th of that of UPS. In addition, Chinese airlines criticized the stringent US visa policy which discouraged Chinese citizens from travelling to the US. They argued that any relaxation of the restrictions on operations would only benefit the US carriers and leave the Chinese industry in a more difficult, less competitive situation.

With different expectations from different airlines, CAAC had to consider how to address the imbalanced growth of the industry, how to satisfy the different stakeholders and how to reach an agreement with the US while at the same time protecting its own industry. With the above considerations in mind, the Chinese believed that the priority for them would be to review the implementation of the 2004 Protocol and address the imbalance rather than to agree to a significant expansion of any arrangements. It would be acceptable to designate more carriers with some reasonable capacities entitlements but not new frequencies to the incumbents. It would welcome more direct flights to the Central, Western and Northeastern regions of the country but not much increase to the hub airports in Beijing and Shanghai due to their slot shortages. They were happy to see the removal of restrictions on cargo operations but not on passenger services.

With such different agendas, the first round of discussions held in April 2006 did not bring about much consequence. The following months saw both parties meet up several times in an attempt to minimize the gap and differences. The US acknowledged the pressure and challenges encountered by their Chinese counterpart, while the Chinese appreciated the efforts the US made in giving their support to the Chinese industry. Both parties hoped that meaningful progress could be made toward the amendment of the 2004 Protocol so as to establish a good foundation to fully liberalise the bilateral aviation market within the foreseeable future. Eventually, at the 6th round of discussions held in April 2007 in China, an agreement, the 2007 Protocol, was reached.

6.5.5.2 Protocol agreed

The 2007 Protocol was officially signed in July in Seattle during the second Sino-US SED discussions, as part of a package reached between the two countries on a wider

range of topics. The Protocol further removed restrictions on the designation of carriers, capacity and codeshare arrangements. For instance, China could designate unlimited number of carriers to operate passenger services to any points between the two countries as of 1st August 2007 while the US could apply the rights as of 2011. Both can operate unlimited cargo services between the two countries via any intermediate and beyond points with full traffic rights. In terms of capacity, up to 160 frequencies per week could be introduced to destinations in Zone One in China in a phased-in manner by 2012, compared with 133 for Zone 1 in 2004's Protocol, and unlimited frequencies to be operated to China's Zone 2 and 3, while cargo capacity could be determined freely by carriers without any restrictions. The Protocol had included Guam and the Northern Mariana Islands as US destinations which could be operated with unlimited frequencies by carriers of both parties. The most significant commitment was that both parties acknowledged that the mutual ultimate objective was the full liberalisation of the bilateral air transport market, hence, agreeing to begin, no later than March 25, 2010, to negotiate such an agreement and timetable.

6.5.5.3 Reactions of stakeholders and implementation of the Protocol

Despite the outcome still fell short of the US expectations (Schofield, 2007), which was optimistic that at least a tentative Open Skies could be reached, the US regarded the deal as a significant step toward a full liberalisation with a timetable being agreed for further negotiations. The agreement would stimulate some \$5 billion in new business and enable the US carriers to take advantage of China's booming aviation market which had been growing at 17 percent annually and brought the two countries one step closer to each other (Russell, 2007). The US Embassy officials in Beijing claimed that the agreement would enable US carriers to stay right ahead of the curve with the anticipated significant increase in demand in both passenger and cargo traffic over the next couple of years, which were getting most of the high-yield traffic on Sino-US routes carrying 59 percent of overall passengers in 2006 (Russell, 2007).

The US carriers applauded the agreement and responded with significant enthusiasm (Russell, 2007). The elimination of restrictions on cargo operations allowed an unfettered access to China by the US shipping giants such as FedEx and UPS, both of

which had previously expanded remarkably their services in China by setting up cargo hubs in Guangzhou and Shanghai respectively. Delta, in its search for new and lucrative international routes following a period of services cuts after the 911, considered its prospective Atlanta-Shanghai service the best opportunity to recover from its bankruptcy protection (Russell, 2007). Northwest was able to launch its long-planned direct services to Guangzhou and increase capacities to Beijing and Shanghai. United won the route licence for its planned Washington-Beijing direct flight, the largest segment in the market that had not been served. The DoT selected United due to the consideration that the first ever service between the two capitals would offer the opportunity to enhance the political and economic ties between the two countries (Beane, 2007).

Again, like what happened in 2004, the Chinese side responded with a mix of welcome and criticism. Jade Cargo successfully secured its route licence to operate all-cargo flights while Hainan Airline was awarded the right for Beijing-Seattle services. The incumbents were still concerned about their competitiveness, with China Eastern's Chairman Li Fenghua being quoted as saying that he did not want to see international flights open too fast because the income of all the three major carriers on international routes was generally much lower than that on domestic routes (Russell, 2007). In only six months time, 4 of the US passenger carriers were able to increase their frequencies to 70 weekly (310 per month) attracting unprecedented traffic between the two countries, while the Chinese passenger carriers only managed to maintain 36 weekly (158 monthly) flights. United itself was providing 155 frequencies in January alone (Russell, 2007) (Table 6.7).

Table 6.7 Schedule of Sino-US passenger frequencies in January 2008 (monthly).

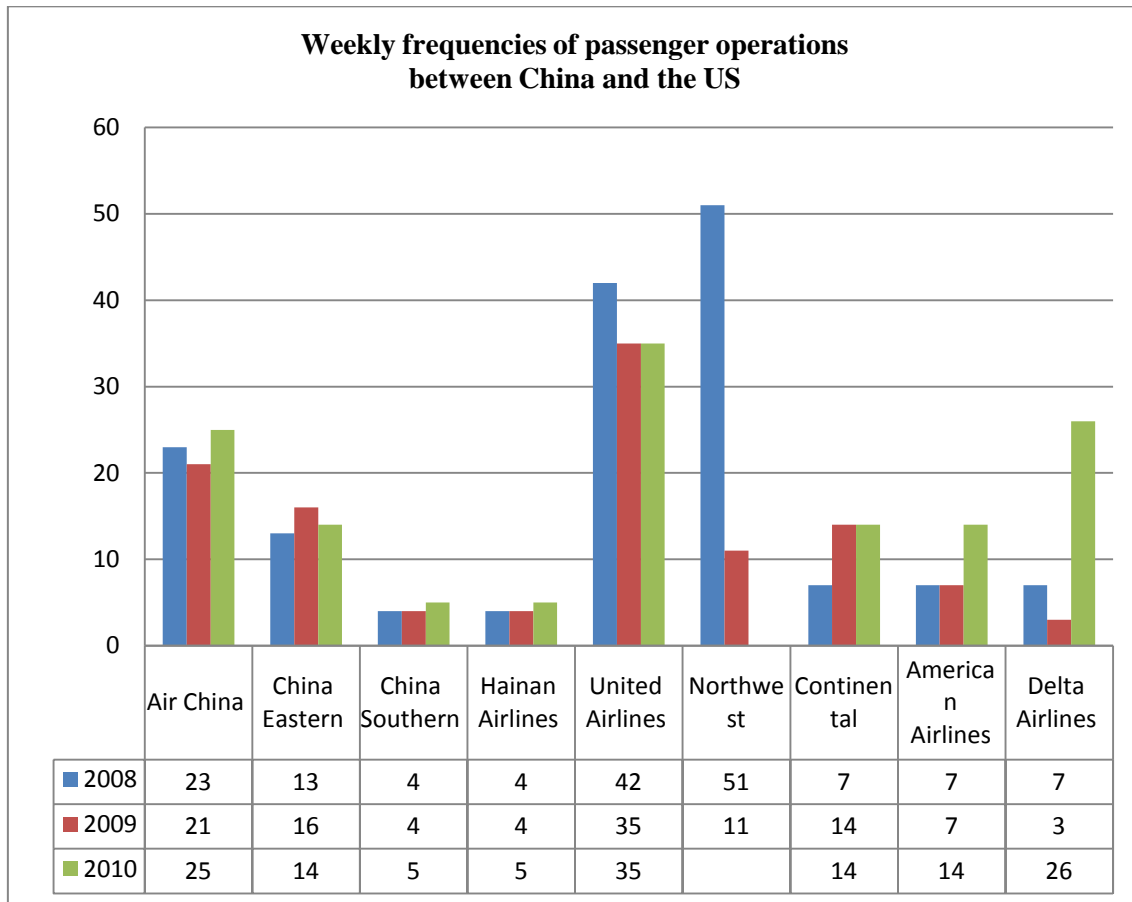
Carrier	Route	Frequencies
American	Chicago-Shanghai	31
Continental	Newark-Beijing	31
United	Washington-Beijing	31
	Chicago-Beijing	31
	Chicago-Shanghai	31

	San Francisco-Beijing	31
	San Francisco-Shanghai	31
Northwest	Detroit-Beijing	31
	Detroit-Shanghai	31
	Honolulu-Guangzhou	31
Air China	Beijing-New York	31
	Beijing-Los Angeles	31
	Beijing-San Francisco	31
China Southern	Guangzhou-Los Angeles	22
China Eastern	Shanghai-New York	12
	Shanghai-Los Angeles	31

Source: 2007 Fourth quarterly and annual highlights, www.tinet.ita.doc.gov

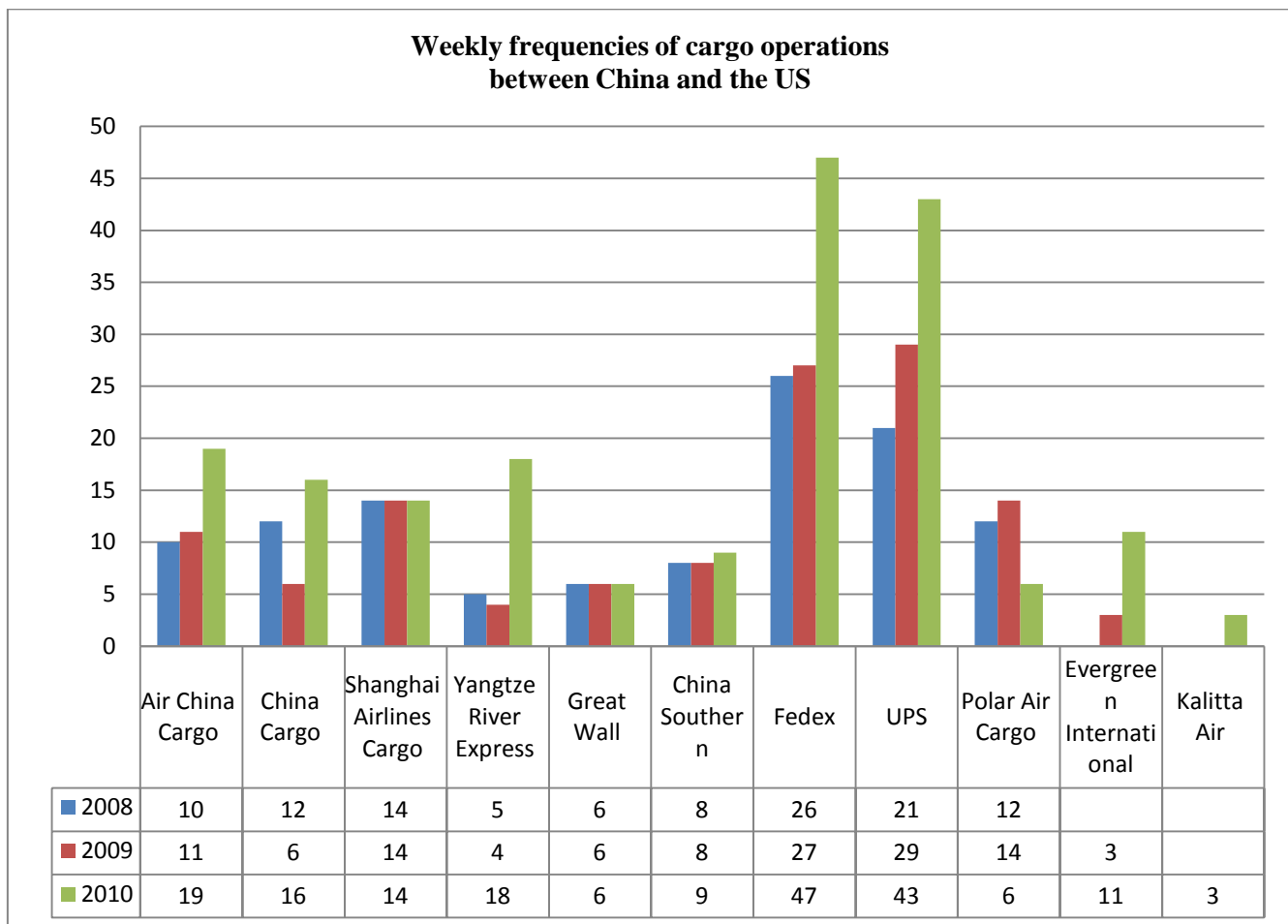
After the 2007 Protocol, China's economy maintained strong growth and had surpassed Germany in 2008 to become the world's top exporting nation registering \$1.47 billion measured by value of the exports, taking 9.2 percent of the world total, while the US ranked the 3rd registering \$1.3 billion exports in value terms with 8.1 percent of the world total. The US imported \$273 billion from China, accounting for 19 percent of its total, compared with its \$81 billion exports to China, accounting for 6.7 percent of its total (DoT, 2010). However, the rapid growth of bilateral trade between the two countries only led some carriers to increase the capacity moderately, while others such as China Eastern and United had adversely decreased their frequencies in 2010 (Figure 6.19 and 6.20). Statistics from the US DoT shows that none of the mainland Chinese airports was able to capture a place in the league of the top ten destination cities for US outbound air freight, though Shanghai airport took a 4th ranking in terms of inbound freight, with 247 thousand tonnes of cargo shipped in 2008 (Table 6.8) (DoT, 2009).

Figure 6.19 Comparison of weekly frequencies of passenger operations between China and the US from 2008 to 2010.



Source: www.caac.gov.cn

Figure 6.20 Comparison of weekly frequencies of cargo operations between China and the US from 2008 to 2010.



Source: www.caac.gov.cn

Table 6.8 Top 10 airport pairs for US international outbound and inbound air freight by weight: 2008.

Rank 2008	US airports	Foreign city	Volume (in thousand tonnes)
Export			
1	Anchorage	Seoul, South Korea	198
2	Anchorage	Tokyo, Japan	157
3	Anchorage	Hong Kong, China	145

4	Anchorage	Taipei, Taiwan China	144
5	Miami	Sao Paulo, Brazil	103
6	Miami	Bogotá, Colombia	93
7	Honolulu	Sydney, Australia	71
8	John F. Kennedy, New York	London, UK	63
9	O'Hare, Chicago	Frankfurt, Germany	49
10	John F. Kennedy, New York	Brussels, Belgium	49
Imports			
1	Anchorage	Seoul, South Korea	455
2	Anchorage	Taipei, Taiwan China	328
3	Anchorage	Hong Kong, China	316
4	Anchorage	Shanghai, China	247
5	Miami	Bogotá, Colombia	198
6	Anchorage	Tokyo, Japan	154
7	Miami	Guayaquil, Ecuador	89
8	Los Angeles	Tokyo, Japan	88
9	Miami	Lima, Peru	87
10	Miami	Santiago, Chile	76

Source: DoT, 2009

6.6 The future

It has been three decades since China and the US resumed bilateral air services. Starting from 2 designations on 2 routes with 4 frequencies in 1980 to unlimited designations on unlimited routes to Zones 2 and 3 with unlimited frequencies in 2007, the arrangements has significantly facilitated bilateral trade and enhanced the exchange between the two countries. Table 6.9 highlights the key points of the Sino-US agreements concluded

over the last three decades, while table 6.10 provides detailed information of the airlines operating in the market as of 1980.

Table 6.9 Key points of bilateral arrangements over the last three decades.

Year	Number of designated carriers	Routes	Capacity (total weekly frequency)	5 th freedom traffic rights	Codeshares
1980	2 for each side	2	4	No	No
1992	3 for each side	3	27		Yes
1999	4 for each side	3	54	No limitation at intermediate and beyond points	Yes
2004	9 for each side	Unlimited	133 between any points in the US and Beijing, Shanghai and Guangzhou by April 2007; 249 in total for all destinations	No limitation on cargo, Limited for passengers between China and Japan sector	Yes
2007	Unlimited for China, 11 for the	Unlimited	227 between any points in the US and Beijing,	No limitation on cargo, Limited for passengers between	Yes

	US		Shanghai and Guangzhou by April 2010;	China and Japan sector	
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Source: adapted from the amendments concluded in 1980, 1992, 1999, 2004 and 2007

Table 6.10 Carriers operating in Sino-US market with year of market entry.

	Combination service		All cargo service	
Year	Chinese carrier	US carrier	Chinese carrier	US carrier
1980		Pam Am		
1981	CAAC			
1984		Northwest		
1986		United replace PamAm		
1987	Air China to replace CAAC			
1991	China Eastern			
1992				Evergreen International
1993			Air China Cargo	FedEx replace Evergreen International
1997	China Southern		China Cargo replace China Eastern's cargo operation	
2001				UPS
2004			Shanghai Cargo	Polar Air Cargo
2006		Continental American		
2007			Yangtze River Express	

2008	Hainan Airlines	Delta	Great Wall Jade Cargo	
2009				Evergreen International
2010				Kalitta Air

Source: compiled by the author from various sources

Over the years, the US has been proactively promoting “Open Skies” around the world with a view that airlines are entitled to engage in business and international trade without restrictions on competition. “Freedom of the air” should facilitate international trade and tourism by acknowledging the rights of airlines to participate in the air transport industry on the basis of equal opportunity (Beane, 2007). On the other hand, China believes that it has made significant progress in opening up its market and integrated into the global economic system, and that international air transport is a political instrument as well as an economic activity which should be used to leverage and optimize the national interests (Li, 2010). With a “proactive, progressive, orderly and safeguarded” approach toward liberalization of international air transport, China holds that the pace for liberalization should be appropriate to allow Chinese airlines to enhance their competitiveness and develop the capability of dealing with the Open Skies circumstances effectively (Li, 2010). Only in so doing, can Chinese airlines not be forced out of the market as a result of Open Skies due to their weak marketing, poor branding and shortage of management skills (Wolf, 2007).

The continuous close political and trade relationship between the two countries will no doubt require more transportation to satisfy business needs. Despite the commitment made in the 2007 Protocol that both parties would resume discussions no later than March 2010, the two actually did not meet up until June with little being achieved due to divergent interpretations about the timetable for a full Open Skies deal, as well as different considerations that both parties have. As liberalization has now become an irreversible trend for international air transport, China has to keep up with the pace. Looking into the next round of discussions, the US side was hopeful of determining a roadmap for a full Open Skies within a certain period of time, while the Chinese, though acknowledging the commitment of agreeing the deal, wanted a longer period of time so

as to get its industry well prepared. As both parties were in close contact in negotiating the deal, it still remains to be seen when the full liberalization will be achieved.

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Chapter 7 China's policy towards China-Netherlands and China-UK markets

7.1 EU and its common air transport policy

The creation of a European common market was an objective of the Continent since the conclusion of the Treaty of Rome in 1957. While in many sectors economic unification was achieved relatively easily, creating a single market for air transport has proven to be a difficult endeavour (Dempsey, 2004). The challenge not only came from the applicability of the concept of a common market in the Treaty of Rome to the industry within the European Community (EC) (Goh, 1997), which is governed by the bilateral regime vested in the Chicago Convention, but also from the individual governments of Member States which regarded international air transport within and beyond the EU as an integral part of their overall national economic policy. Though the European Commission recognised the necessity to pursue a common air transport policy in 1962 and issued several communications to the Council of Ministers in the years of 1967, 1971 and 1973 respectively, its efforts failed to propel the Council into taking significant action.

The deregulation of domestic air transport in 1978 in the US as well as its initiative to promote Open Skies outside the country had been a strategic push for the EU to reconsider speeding up the pursuit for a common air transport policy. Yet, it was not until 1987 that the First Package of liberalisation was introduced, that brought the EU competition rules to international air transport between the Member States (Goh, 1997). The successful implementation of the First Package was followed by the Second Package in 1990 and Third Package between 1993 and 1997, which together fully liberalised the EU air transport market, removing all restrictions on designation, ownership, cabotage and pricing. As of July 1994, the provisions of the three Packages were extended to the whole EEA, with Norway and Iceland being included. "Community air carrier" is thus recognised and accepted instead of national designation, with any such airline being entitled to equal market access inside the entire internal market (Liang, 2004).

7.1.1 External aviation policy and the “horizontal agreement”

The common air transport policy adopted through the Three Packages over a period of ten years had not been extended to air transport relations beyond the Community before 2002 (Goh, 1997). The sovereign governments of individual Member States were still negotiating their own bilateral ASAs with the third parties outside EU. In the late 1990s, quite a few EU Member States including Denmark, Sweden, Finland, Belgium, Luxemburg, Austria and Germany had concluded or been negotiating with the US for an Open Skies agreement, which ran counter to the general thrust of EU strategy for air transport liberalisation (Williams, 2009). The practice was criticised by the Commission, which, being authorised by the EC Treaty to conduct international trade negotiations, complaining that the individual arrangements between Member States and the US did not reflect the EU’s core values in that it did not protect the interest of the EC as a whole, hence jeopardising the benefits of those that had not concluded Open Skies deals with the US.

Being ignored of the warnings, the Commission took a number of EU Member States to the European Court of Justice (ECJ) in December 1998, accusing them of having breached their duties under the EC Treaty based on the grounds that only the European Commission had the treaty-making power with a third party outside the EU. It argued that such power of the EC was necessary for the attainment of the objectives of the EC Treaty and, in particular, for the avoidance of discriminations and distortions of competition and impairments of EC laws in general (Bartlik, 2007). It stressed that the nationality clauses in the existing ASAs would prevent Community carriers from benefiting from the Community market by depriving them of the right of establishment, thus preventing consumers from gaining the benefits of increased competition.

In November 2002, the ECJ ruled against the Member States, pointing out that in accordance with the Community law, the agreements signed between those Member States and the US infringed the rights of Community carriers to non-discriminatory market access to routes between all Member States and third countries, hence constituting an obstacle to the freedom of establishment, as the opening of European skies to US carriers was not reciprocal for all EU carriers (European Commission,

2003). Although the Member States did not infringe the treaty-making power of the Community based on Regulation 95/93, some of them infringed their obligations according to Article 10 EC and Regulations 2409/92 and 2299/89 by concluding Open Skies agreements with the US as these agreements contained regulations concerning the applicable fares on intra-Community routes and the use of CRS (Bartlik, 2007). It was these subject matters that fell into the exclusive treaty-making power of the European Community. The Court also found that the national ownership and control requirements in those bilaterals cited by the EU actually violated a central principle of the European Treaty itself (Williams, 2009). The causal factor was found to be located in the designation process, where the nominated carriers were either owned or controlled by the signatory Member States, which had a serious effect in law because it denied the rights of airlines in other Member States to receive any form of national treatment after the ASA was duly signed and sealed (Williams, 2009). The Court further identified that an additional 1,500 existing agreements signed with foreign countries other than the US were in violation of the Treaty and measures must be taken to amend these ASAs to bring them in conformity with EU law.

Two methods were identified which included either to conduct bilateral negotiations between each Member State concerned and its partners; or to negotiate single “horizontal agreements”, with the Commission acting on behalf of the Member States (www.ec.europa.eu).

The ECJ ruling was a milestone marking the start of a Community external aviation policy, with the Commission playing an important role with certain exclusive responsibilities in external relations in the field of aviation (www.ec.europa.eu). Though Member States were still entitled to negotiate bilaterally with any third country outside the EU, they must work together in a concerted manner with the Commission to bring all air services agreements into conformity with the EU law (Bartlik, 2007). A mechanism has since been established where the Member States must coordinate, update and consult with the EC the progress of any negotiations should they engage themselves with any third country (Geil, 2010).

However, the horizontal agreement does not replace the existing bilateral ASAs, nor will it change the provisions concerning traffic rights (Liang, 2004), rather, it is designed to amend the relevant clauses, such as the nationality clause, in existing ASAs so as to ensure that all EU carriers are eligible to operate on routes between the EU and third countries on a non-discriminatory basis (Liang, 2004). Some key countries were identified including China, Canada, the US, Japan, Australia and New Zealand, with which the European Commission wishes to start negotiations, though it has not necessarily received mandates for such negotiations. The historical Open Skies deals (Stages I and II) concluded with the US in 2007 and 2010 respectively were one of such horizontal agreements negotiated by the Commission with a mandate received from the Council. The EU-US Open Skies agreement is considered a model for other Open Skies because it has tackled “nationality clause”, “ownership” and “cabotage” issues, which have remained unchallenged in any of the previous Open Skies agreements between the US and its counterpart signatories, although they are not a problem within the EU which is the first fully liberalised region.

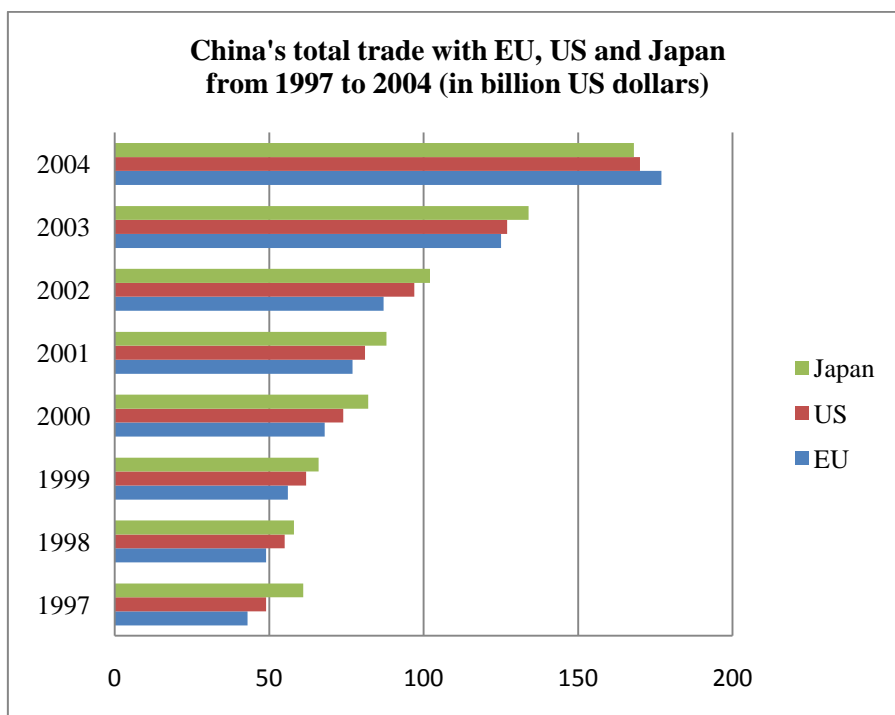
Between June 2003 and December 2008, the negotiations at bilateral level have led to changes with 60 partner States, representing 132 bilateral agreements corrected. At Community level, horizontal negotiations have led to changes with 37 partner states and one regional organisation with 8 Member States, representing an additional 651 bilateral agreements being corrected (www.ec.europa.eu).

7.1.2 China-EU economic relations

The economic dimension has always been an important element in China-EU relations. From the Chinese perspective, improved economic ties and access to advanced technology from leading nations such as those in Europe is significant in that it would help China to counter the perceived US containment policies (Casarini, 2006). Maintaining and enhancing a close relationship with the EU is regarded as a highly strategic long-term objective by the Chinese leadership (Casarini, 2006). The Chinese government is determined to strengthen this strategic relationship by encouraging expanded bilateral trade activities and a wide range of economic cooperation in industrial sectors. Statistics showed that China-EU trade increased 112.8 times from

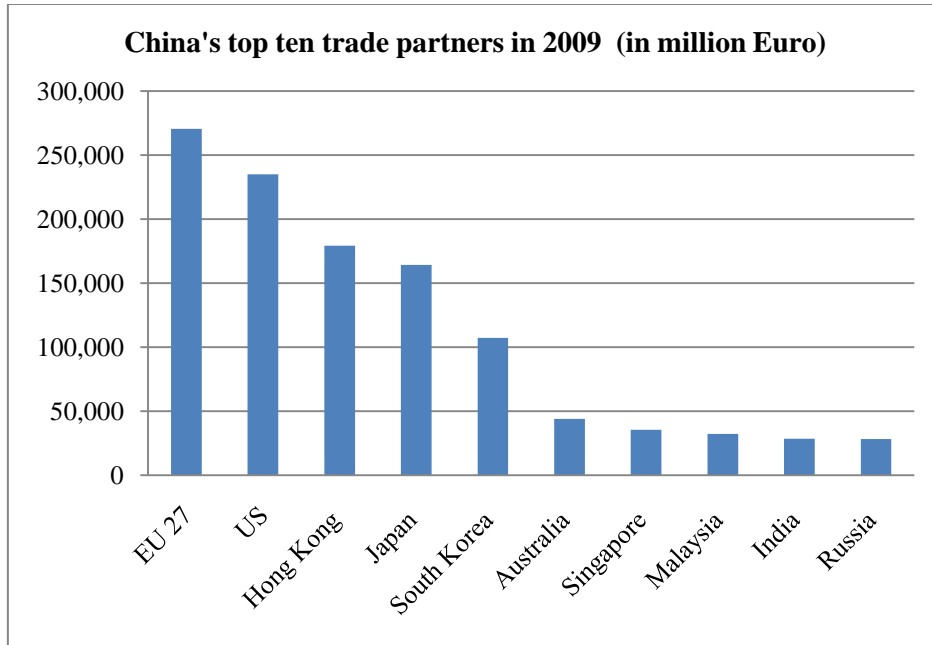
\$3.3 billion in 1978 to \$372.3 billion in 2009. Until 1997, the EU's trade with China had grown slowly, with a recorded trade value of \$43 billion, far behind the US and Japan. However, a phenomenal growth occurred in 2003, when both sides published their respective Policy Papers to reiterate their commitment to a long-term, stable and strategic partnership. The total trade value in that year soared to \$125.3 billion, just narrowly behind that with the US (\$126.5 billion) and Japan (\$133.6 billion). In 2004, the EU had overtaken both of them, becoming China's biggest trade partner with \$177.2 billion reported (Figure 7.1). The momentum has been kept to date with EU remaining China's No. 1 trade partner, recording \$372.3 billion (€270.4 billion) trade in 2009, compared with that with the US (€235 billion) and Japan (€164.2 billion) (Figure 7.2).

Figure 7.1 Comparison of China's total trade with the EU, the US and Japan from 1997 to 2004 (in billion US dollars).



Source: Wai (2005)

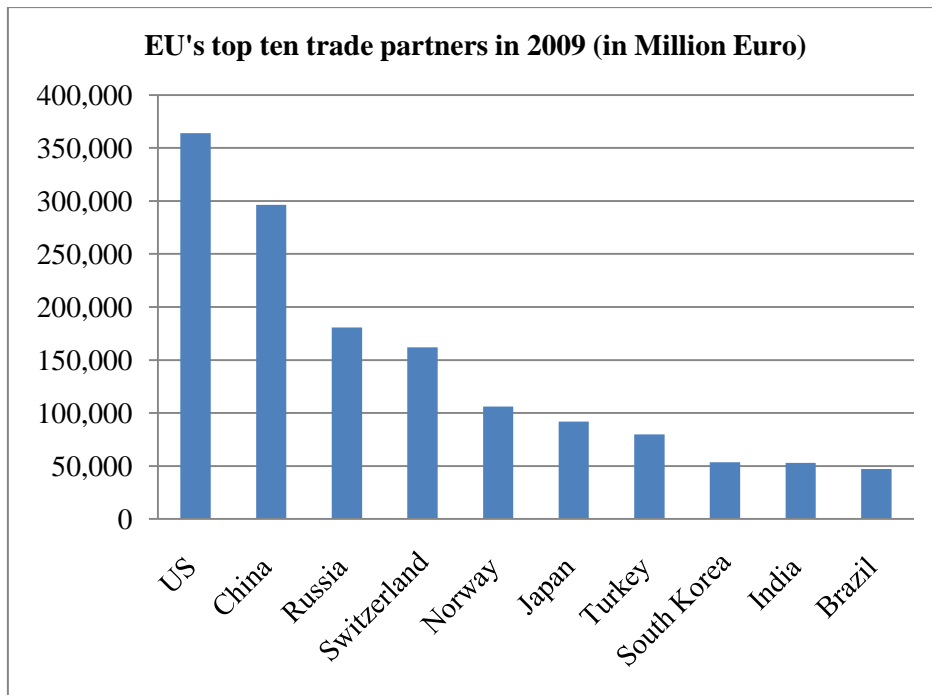
Figure 7.2 China's top ten trade partners in 2009.



Source: The EU DG Trade Statistics Bulletin, 2010

From the EU's perspective, China represents prospective opportunities as a result of its reform, market size, growth rate and great potential for future development, though any changes in China's demand for oil and raw materials would have an impact on the EU's economy (Casarini, 2006). Believing China is one of the most important economic markets for its economic security, the EU relies on China for the importation of a proportional amount of manufactured goods and for exports of its professional services (Casarini, 2006). In 1980, China only accounted for 0.7 percent of the EU's imports and 0.9 percent of its exports. In 2004, however, these figures rose to 12 percent and 5 percent respectively (Chen, 2009). In the same year, China's exports to the EU were recorded at \$107 billion (18.1 percent of its total), though still behind the US at \$125 billion (21.1 percent), but above Japan at \$74 billion (12.4 percent) (Chen, 2009). Ever since then, the bilateral trade has been expanding rapidly, with China becoming the EU's second largest trading partner in 2009, just behind the US (Figure 7.3).

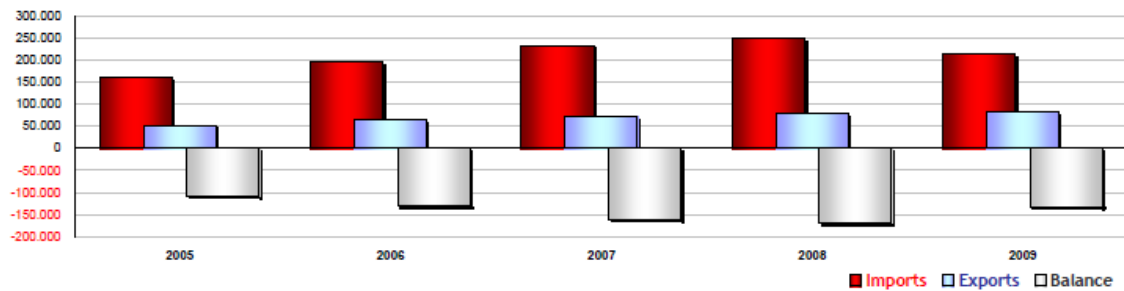
Figure 7.3 The EU's top ten trade partners in 2009.



Source: The EU DG Trade Statistics Bulletin, 2010

Like China-US economic relations, a trade deficit also exists between China and the EU. This is caused, on the one hand, by the fact that China exports a majority of the finished consumer goods, which are required in the European market, while on the other hand, it is also due to the fact that exports from the EU to China are not strong enough. Between 2000 and 2004, the trade deficit between the two parties had almost doubled, rising from minus €48.6 million in 2000 to minus €78.7 million in 2004. For the period 2005 to 2009, the EU's exports to China only increased mildly compared with its imports from China, which grew by around 16.5 percent, resulting in a even bigger trade deficit with €128 billion being recorded in 2009 (Figure 7.4), although the EU ran a surplus of €5.0 billion on trade in services with China the same year.

Figure 7.4 The EU's trade balance with China between 2005 and 2009 (in million Euro).



Source: The EU DG Trade Statistics Bulletin, 2010

At EU Member State's level, Germany, the Netherlands, the UK, France and Italy are the most active trade partners with China. Germany is able to secure large scale projects as a consequence of leveraging political influence such as paying state visits to China (Casarini, 2006). Since 1998, Germany's exports to China have been growing between 20 and 28 percent annually, resulting in it becoming China's largest EU trade partner in 2002 while China has been Germany's second largest export market outside Europe after the US. Statistics available for 2008 showed that China's exports to Germany accounted for 20.2 percent of China's total exports to the EU and its imports from Germany were more than 40 percent (Chen, 2009). The UK adopts a strategy of promoting commercial activities with political support to back their businesses in their pursuit in the Chinese market, with the exchange of state visits always bringing about the conclusion of commercial contracts between the two countries (Casarini, 2006). The Netherlands, though small in terms of size, is big in trade with China. In 2008, China's exports to the country accounted for 16 percent of its total exports to the EU and its imports were about 4 percent (Chen, 2009). Table 7.1 provides details of the bilateral trade between China and five EU Member States in 2008, which, when added together, took 68 percent of the total trade volume between China and all EU Member States.

Table 7.1 Percentage of trade between China and the top five EU Member States in 2008, compared with all EU Member States.

Country	Trade volume	Export	Import	Trade balance
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Germany	27.0%	20.2%	42.1%	2.1%
Netherlands	12.0%	15.7%	4.0%	25.4%
UK	10.7%	12.3%	7.2%	16.6%
France	9.2%	8.0%	11.8%	4.8%
Italy	9.0%	9.1%	8.8%	9.3%
5 in total	67.9%	65.2%	73.8%	58.1%

Source: Chen (2009)

7.2 Overview of the China-EU air transport market

The China-EU air transport relationship started at bilateral level, with France being the first to recognise the legitimate status of the government of the PRC. The ASA was signed in 1966 allowing Air France and CAAC (Air China since 1987) to operate between the two countries. This was followed by other EU Member States such as Denmark, Italy, Greece, Sweden, Germany and the UK in the 1970s and the Netherlands in the 1990s. By 2009, of the 27 EU Member States, 25 had concluded ASAs with China (Table 7.2), with only two of them having no air transport relations, namely Lithuania and Slovenia (www.caac.gov.cn). However, not every ASA has been implemented. According to Liang's analysis conducted in 2004, between 1998 and 2003, only 16 Member States operated direct services to China. The number dropped to 9 in 2004 due to various economic considerations (Liang, 2004).

Table 7.2 Bilateral ASAs between China and EU Member States.

Serial Number	EU member state	Date of taking effect
1	France	1 June 1966
2	Denmark	18 May 1973
3	Greece	14 January 1975
4	Italy	29 January 1975
5	Sweden	1 June 1975
6	Belgium	20 April 1975
7	Finland	15 March 1976
8	Germany	24 May 1978

9	Spain	21 September 1978
10	the UK	1 November 1979
11	Austria	27 January 1986
12	Poland	1 August 1986
13	Czech Republic	27 September 1988
14	The Netherlands	23 May 1996
15	Hungary	20 June 1997
16	Malta	1 September 1997
17	Ireland	(signed on 14 th September 1998 but not effective yet)
18	Estonia	3 January 2000
19	Latvia	1 February 2000
20	Luxemburg	18 November 2002
21	Romania	No date available
22	Bulgaria	No date available
23	Portugal	Signed but not effective yet
24	Cyprus	No date available
25	Slovakia	Signed in 2007 but not effective yet

Source: Adapted from Liang (2004)

One consequence out of such enlargement of the bilateral relationship between China and the EU is a more even distribution of traffic between the two parties. In the early 1990s, passenger traffic between China and the EU was concentrated on the 3 country-pair markets, i.e. China and Germany, France and the UK, which in total accounted for more than 90 percent of the China-EU market. In 2008, the figure dropped to 65 percent (Lu and Finger, 2010). In terms of cargo, China and Germany, the Netherlands and Luxemburg are the three biggest country-pair markets, which accounted for more than 50 percent of the total China-EU market in 2008.

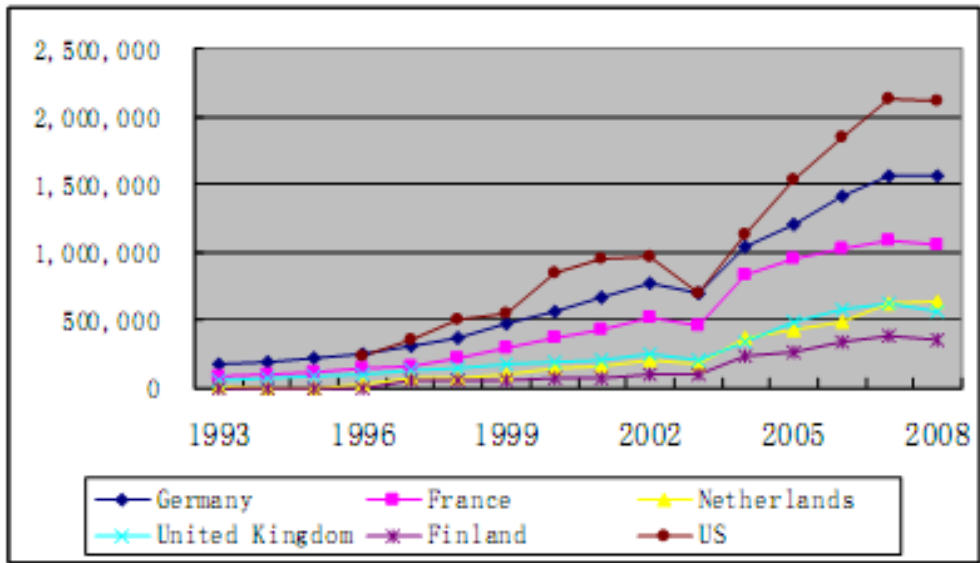
Traditionally, the bilaterals between China and EU Member States were restrictive in terms of market access, capacity, designation and pricing. However, as China has begun to liberalise its international market since the 21st century, market access arrangements have been expanded with such EU Member States as Germany, France, the Netherlands

and the UK in terms of third, fourth and fifth freedom traffic rights, route schedules and codeshare arrangements (Liang, 2004), although not comparable with the relaxed arrangements in the Open Skies deals. Multiple and/or unlimited designations are allowed in 10 out of the 25 agreements, including Germany, France, the Netherlands and the UK, resulting in more than one carrier from each side operating between the country pair markets (Liang, 2004).

In addition, restrictions on points of operations are removed in a handful of agreements with airports served being significantly increased which can be selected at the discretion of the operating airlines. For example, the Sino-Germany arrangement reached in 2002 allowed German designated airlines to fly into Beijing and 7 other points in China at their own discretion. Likewise, Chinese carriers were allowed to operate to Frankfurt and 7 other destinations in Germany at the discretion of the Chinese side. Though restrictions on capacity are still in place, airlines are given more flexibility to introduce more frequencies in a phased-in manner to satisfy market demand. For example, the agreement with Germany allowed airlines of each side to operate up to 36 frequencies per week for passenger flights and 14 for cargo flights. The capacity has almost been doubled in the recently agreed arrangements with France, Austria, Italy and the Netherlands (Liang, 2004). More significantly, commercial cooperation is encouraged and, in some instances, third-party codeshare arrangements are permitted in order to support the airlines to pursue network development (Liang, 2004).

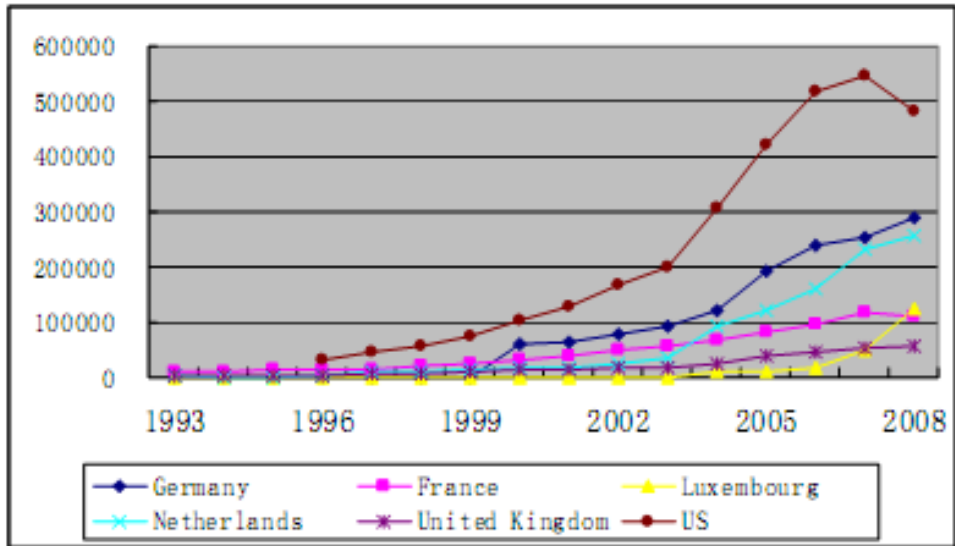
The relaxation of the restrictions has brought about significant traffic growth over the decades. According to Lu and Finger (2010), between 1993 and 2008, passenger traffic on China-Germany, France and UK markets increased by 789 percent, 1029 percent and 826 percent respectively, while the freight transport on China-France, the Netherlands and the UK markets increased by 960 percent, 4995 percent and 1911 percent respectively. Figures 7.5 and 7.6 show the increase of passenger and freight traffic between China and some selected EU Member States compared with that of China-US between 1993 and 2008.

Figure 7.5 Passenger traffic between China and 5 EU Member States compared with China-US between 1993 and 2008.



Source: Lu and Finger, 2010

Figure 7.6 Freight transport between China and 5 EU Member States compared with China-US between 1993 and 2008.



Source: Lu and Finger, 2010

7.3 China and the Netherlands

7.3.1 The Netherlands and its air transport industry

Comprising only 34,000 square kilometres with more than 16 million people, the Netherlands is strategically situated right at the heart of Western Europe, which provides a main gateway to Europe and the northwest of the Continent, making it one of the largest and most important transport and distribution centres in the world. The opening of the EU's internal borders and the introduction of the Euro have strengthened the leading position of the Netherlands in transportation, distribution and logistics, which have helped to enhance the competitive strength of its transport industry that accounts for 8 percent of the country's GDP and a large share of the European market.

As a shift in economic activities is occurring around the world, the Netherlands government fully appreciates the demand for transport and logistics and is ambitious to reinforce the country's role as the hub of Europe. The White Paper for Aviation issued in April, 2009 recognised that aviation sector would play a pivotal role in the country's aim to further enhance its allure and appeal for business and to remain as one of the most competitive economies of the world. Schiphol Airport and KLM will, thus, have a key role to play in the country's initiative. The government is committed to encouraging Schiphol Airport, one of the home bases and hubs for Air France-KLM and its SkyTeam partners, together with other national airports to develop an extensive route network so as to offer the most convenient connections appropriate to the desired spatial-economic development of the region and to link the country directly to the world's major established and new economic centres (The Ministry of Infrastructure and Environment, 2009).

Schiphol was ranked Europe's fifth largest airport in terms of passenger throughputs, handling 391,264 air transport movements and 43.6 million passengers, just behind London Heathrow, Paris Charles de Gaulle, Frankfurt and Madrid (Schiphol Airport Annual Report, 2009). This represented a 8 percent decrease in passenger traffic compared with 2008, which was mainly caused by the global financial crisis. In terms of cargo, the airport was able to maintain its third place in 2009, handling 1.3 million tonnes of freight, behind Paris Charles de Gaulle and Frankfurt (Schiphol Airport

Annual Report, 2009). Notwithstanding the decrease of traffic, the airport still offers the highest quality network serving 284 destinations in 93 countries by 92 scheduled airlines.

KLM is the world's oldest airline still operating under its original name. Set up in 1919 but merged with Air France in 2004 to form the Air France-KLM Group and as the founding members of SkyTeam, it has become the world's largest airline partnership in terms of financial turnover (KLM Annual Review, 2009-2010). Operating under its own brand with a fleet of 205 aircraft, KLM served to 151 destinations in 63 countries and achieved 74 billion RPK and 6.3 billion RTK in 2009. Combined, Air France and KLM have generated €19.2 billion in aggregate annual revenues and served 226 destinations worldwide. KLM Group (including KLM UK/Cityhopper, Transavia and Martinair, which are fully owned by KLM) booked revenues of €8 billion in the fiscal year 2009—2010 (KLM Annual Review, 2009-2010).

7.3.2 The government agency responsible for international air transport policies

The Ministry of Transport, Public Works and Water Management used to be the government agency in the Netherlands responsible for the country's transport system including aviation. The Aviation Negotiation Office headed by the Chief Negotiator was the unit mainly overseeing the development of the nation's international air transport policies and negotiating bilateral air services with its counterparts. To optimise the resources and better coordinate work, the Ministry of Transport, Public Works and Water Management has recently been merged with the Ministry of Housing, Spatial Planning and the Environment to form the new Ministry of Infrastructure and Environment. The Aviation Office will retain its responsibilities and report to one of the Directorate Generals. It is working to maintain strong transport connections through multi-modes provisions to improve traffic flow with an aim of strengthening its strategic position as a hub for Western Europe and further to Africa, Asia and Eastern Europe. One of the key areas of focus adopted by the new Ministry is accessibility, with a free flow of traffic in a clean and safe environment (<http://english.verkeerenwaterstaat.nl/English>).

7.3.3 The views towards an open economy

The Netherlands' relatively small size has forced the country to look outwards and be innovative, which has helped to create a relatively large economy (Wong, 2009). Over the centuries, the country has been featured with an open and export-oriented economy with trade and distribution being one of the important driving forces (Staniland, 2003). Aiming at achieving commercial success, the Netherlands government would obtain any traffic rights where possible that would enable its airlines to expand internationally while the airlines would strive to be competitive and efficient to generate revenues and profits in their operations (Staniland, 2003).

Such an open view towards the economy has enabled the Netherlands government and its businesses to be proactive and innovative in pursuing market opportunities. Removing restrictions for a liberalised operational environment has been one of the main objectives of the Netherlands government in supporting its businesses in their international commercial expansion initiatives. Such a philosophy has been guiding the Netherlands government in its bilateral air transport negotiations with the rest of the world, including the US and China. It was the first country that signed the early form of an Open Skies agreement with the US in 1978, which gave KLM access to major US cities such as Los Angeles and Atlanta. It was again the first country that signed a real Open Skies agreement with the US in 1992 that built on the strategic alliance formed between KLM and Northwest Airlines in 1988, which not only led the way for global airline alliances but also marked a new era for the global aviation industry.

7.3.4 Bilateral air transport negotiations between China and the Netherlands

Although China and the Netherlands started their diplomatic relations in 1954, the bilateral ASA had not been signed and did not become effective until May 1996. Ever since then, 4 rounds of consultations have been conducted respectively in 1998, 2003, 2006 and 2010, which together have removed the restrictions on airline operations between the two countries, albeit the process being gradual and progressive. In 2010, the Netherlands became one of the first EU Member States that amended its bilateral ASA with China to bring it into conformity with the EU law, allowing EU designation. The following is an overview of the bilateral consultations as they have evolved.

7.3.4.1 Signing the bilateral ASA

The diplomatic relationship that began in 1954 between China and the Netherlands did not bring about an immediate discussion and conclusion of a bilateral ASA. Rather, it took both parties 25 years before they sat together for such a negotiation, leading to the signature of an ASA in January 1979. However, the agreement failed to enter into force due to the Chinese side failing to complete the legal procedures as a consequence of the air transport services launched by KLM to Taiwan in January 1983. The service was considered a serious political offence by China, which urged the Netherlands to address the issue to its satisfaction. The following years saw both sides exchange views and visits of senior officials, with an intention to resolve the issue and remove the legal obstacles preventing the launch of direct services between the two countries. The efforts eventually led to a satisfactory resolution in May 1995 when both sides reached an understanding regarding the Netherlands-Taiwan service. The Netherlands agreed that the Taiwan service would be treated as a private commercial operation and China Airlines of Taiwan would remove its national flag on all its flights as of October 1995.

In July 1995, discussions were resumed between the two parties leading to the agreement of a fresh ASA, which was subsequently signed in May 1996 in Beijing and became valid with immediate effect. The agreement allowed both sides to designate one carrier from each side to operate between the two countries with two intermediate points to be discussed and agreed (Table 7.3).

Table 7.3 Arrangements agreed in 1996 between the two countries.

Items	Chinese side	The Netherlands side
Routes for passenger and cargo and weekly capacity	2 for China to Amsterdam	2 for Amsterdam to Beijing for passenger service cargo services for Amsterdam to Guangzhou as a charter
Number of designated carriers	1	1 for passenger 1 for cargo charter operator

(Source: adapted from the Sino-Netherlands ASA agreement in 1996)

The Netherlands designated KLM as its carrier, which inaugurated a direct Amsterdam-Beijing service with two weekly frequencies in April 1996. For the Chinese side, CAAC had to decide which of the three bidders, i.e. Air China, China Eastern and China Southern, was more appropriate for this new operation. Although Air China operated to quite a number of European destinations and China Eastern had just launched China-Germany services, neither of them were successful in this bidding. Instead, China Southern, which was very new to the European market, was awarded the traffic right, which argued that it needed long-haul international services to expand its Southeast Asia-focused network. The carrier launched its first-ever European service between Guangzhou and Amsterdam via Beijing in November the same year. At the same time, it cooperated with Martinair on the carrier's charter cargo service between Amsterdam and Guangzhou.

7.3.4.2 Cautious expansion of traffic rights in 1998

The initial operation of services generated quite some market interest though the demand remained moderately low (Rowland, 2010). KLM was able to achieve 73 percent load factor on its Amsterdam-Beijing route compared with the 42 percent load factor of China Southern on its Guangzhou-Beijing-Amsterdam service in early 1998, two years following the launch. A further consultation was scheduled in June 1998, with one of the objectives from the Netherlands side being to have more frequencies and destinations in China (Rowland, 2010). Martinair, the cargo operator that had been flying to Guangzhou on a charter basis also wanted to become a designated schedule operator.

The eagerness of the Netherlands side to expand operations in the market was not echoed by China. China Southern was not enthusiastic about increasing capacity, nor did it want to see more competitors in the market. It argued that its extensive domestic network and focus on Southeast Asia failed to generate sufficient demand for the China-Netherlands market, which was their only route to Europe. In addition, it was not making any money from its international operations due to the financial crisis in Southeast Asia in 1997. It was concerned that any increase of designated carriers and capacity would only adversely impact the carrier's ability to compete and operate

profitably. It therefore suggested that limitation should be put in place to restrict more carriers from entering into the market so that the carrier could have more time to develop the market.

China Eastern also expressed the view of not including Shanghai as an additional destination in China for the Netherlands, arguing that the airport was short of facilities to accommodate more operations. The fierce competition in the Shanghai market had caused the dramatic decrease of load factors on its services, thus, a protective mechanism should be in place for the benefit of the Chinese airline industry.

Despite the divergent views of the relevant carriers, a package was agreed between the two authorities which moderately relaxed the restrictions on operations for both sides. Routes for passenger and cargo traffic were separated in order to allow more carriers' access to the market. Shanghai was agreed to be another destination for the Netherlands though operations would not start until 1999 when Pudong airport would be open. Frequency increase was allowed to Beijing and both intermediate and beyond points were agreed for cargo operation along with full 5th traffic rights (Table 7.4).

Table 7.4 Arrangements between the two countries in 1998.

Items	Chinese side	The Netherlands side
Routes for passenger and cargo and weekly capacity	7 in total for China to Amsterdam	7 in total, 3 for Amsterdam to Beijing 2 for Amsterdam to Shanghai 2 for cargo services from Amsterdam to points such as Shanghai, Nanjing and Guangzhou
Number of designated carriers	2	2

Source: adapted from the Sino-Netherlands ASA in 1998

The arrangements fulfilled the requirements of Martinair as a second designated carrier to operate an all-cargo service between Amsterdam and Guangzhou provided that Martinair would continue collaboration with China Southern on its cargo operations. It

also gave KLM access to the Shanghai market following other European carriers such as Lufthansa, Air France and SAS, and satisfied its request to increase frequencies on Amsterdam-Beijing to three weekly. Nanjing, a city 254 kilometres east to Shanghai was also included as a destination for cargo operations.

7.3.4.3 The 2003 Agreement

The years following 1998 were a period of honeymoon for China and the Netherlands, both of which enjoyed a burgeoning of economic exchanges. According to Eurostat, between 1998 and 2003, the bilateral trade between the two countries had grown remarkably, reaching a historical high in 2003 with a total trade value of €16.4 billion compared with €5.4 billion in 1999, rendering the Netherlands the second largest trade partner of China in the European Union (Eurostat, 2004).

The traffic demand reflected the sudden booming of the bilateral trade which led the carriers to request an increase in capacity. Both KLM and China Southern applied to their respective authorities to fly more frequencies (Rowland, 2010; Daniels, 2010). They also agreed on codeshare arrangements on their operations covering beyond points which circumvented the regulatory restrictions imposed in the previous arrangements in 1998. Martinair, the cargo operator, wanted to utilise the 5th freedom traffic rights to enable operations via Nanjing to destinations beyond China.

Their efforts were appreciated by their respective authorities. By 2003, before the official discussions were resumed, both KLM and China Southern had successfully managed to have their frequencies and capacity increased to satisfy the market demand. For example, KLM was operating 4 frequencies on its Amsterdam-Beijing route and 5 on Amsterdam-Shanghai route, while China Southern was operating 4 frequencies on its Guangzhou-Beijing-Amsterdam route (2 more than the provisions in the 1998 arrangements). Martinair was able to use the 5th freedom rights granted to extend its services to Bangkok and Sydney via Nanjing.

With such encouraging and promising performance of both sides, the discussions held in 2003 were very pleasant, with the arrangements welcomed by both sides. Compared with the previous agreement in 1998, restrictions on the number of origin airports were

removed, allowing carriers of both sides to originate their services from any cities within their respective territories. For passenger services, a total of 25 frequencies were agreed for each side with any type of aircraft, representing a 400 percent increase compared with that in 1998 (5 frequencies in total). Specifically, KLM could fly 7 weekly frequencies on Amsterdam-Beijing route and 10 frequencies on Amsterdam-Shanghai route, with the rest being allocated to destinations in China such as Guangzhou and Chengdu. Chinese carriers could operate up to 25 weekly frequencies on any routing between China and the Netherlands. On Amsterdam-Shanghai route, both passenger and all-cargo services were allowed. For cargo operations, both sides were given the traffic rights for 14 weekly frequencies. Codeshare arrangements were further encouraged to promote closer collaboration. Tables 7.5 summarises the key points of the agreement reached in 2003.

Table 7.5 Arrangements reached for passenger operations in 2003.

Items	Chinese side	The Netherlands side
Passenger routes and weekly capacity	25 in total for China to the Netherlands and beyond points	7 for Amsterdam to Beijing 10 for Amsterdam to Shanghai 8 for Amsterdam to other Chinese destinations
Cargo route and weekly capacity	14 in total for China to the Netherlands and beyond points	14 in total for Netherlands to China and beyond points
Number of designated carriers	1 for passenger services 1 for cargo	1 for passenger services 1 for cargo

Source: adapted from the 2003 ASA

7.3.4.4 Arrangements reached in 2006

The agreement reached in 2003 had significantly enlarged the traffic rights between the two countries, though restrictions were still in place limiting the number of designated carriers and frequencies on both passenger and cargo operations. Although there was no evidence that the market would require such a big increase in capacity, both governments were visionary and generous in agreeing such an arrangement, which

enabled the carriers of both sides to be well prepared for the prospect of rising market demand.

Since 2003, the bilateral trade between the two countries has kept momentum, with the Netherlands remaining as China's second largest trade partner among the EU Member States. In 2005, the total trade value reached \$28.8 billion, a 34 percent increase year on year, making China the fourth largest trade partner for the Netherlands. By 2006, hundreds of businesses from the Netherlands had made a prominent presence in the Chinese market including big brands such as Phillips, Shell and Unilever, indicating a promising trade prospect between the two countries.

Corresponding with the surge of bilateral trade, both passenger and cargo traffic continued to grow rapidly, with a total of 427,500 passengers and 118,708 tonnes of freight being carried between the two countries in 2005 (www.caac.gov.cn). As a consequence, more carriers demonstrated significant enthusiasm in the market, with two Chinese all-cargo operators, i.e. Jade Cargo and Great Wall launching an all-cargo service in 2006 under provisional route licences due to the restrictions imposed in the 2003 agreement, thus bringing the total number of carriers to five.

Notwithstanding the phenomenal traffic growth between the two countries, airlines had not used up all of their traffic rights by the winter/spring season 2006 (www.caac.gov.cn). Table 7.6 and 7.7 show the status of the utilisation of traffic rights of carriers of both sides, which reveals that although both KLM and China Southern had used their 7 frequency entitlement on Amsterdam-Beijing v.v. passenger route, KLM had only used 7 out of its 10 frequency entitlement on Amsterdam-Shanghai passenger route. In terms of cargo services, neither side had used up their 14 weekly frequency entitlement¹⁹.

Table 7.6 Status of utilisation of traffic rights in 2006 for passenger services.

Airlines	25 frequency entitlement for passenger operations for each side	Actual utilisation of the weekly frequencies
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¹⁹ Great Wall temporarily suspended its five weekly Shanghai-Beijing-Amsterdam-Seoul service in winter/spring season 2006.

KLM	Amsterdam-Beijing, 7	16, (55 percent of the total)
	Amsterdam-Shanghai, 7	
	Amsterdam-Chengdu, 2	
China Southern	Guangzhou-Beijing-Amsterdam, 7	7, (24 percent of the total)

Source: www.caac.gov.cn

Table 7.7 Status of utilisation of traffic rights in 2006 for cargo services.

Airlines	14 frequency entitlements for cargo operations for each side	Actual utilisation of the weekly frequencies
KLM	Amsterdam-Shanghai, 4	9, (64 percent of the total)
Martinair	Amsterdam-Shahjar-Tianjin-Nanjing-Bangkok, 5	
China Southern	Shenzhen-Shanghai-Amsterdam, 5	8, (57 percent of the total)
Jade Cargo	Shenzhen-Amsterdam, 3	

Source: www.caac.gov.cn

In this kind of circumstances, passenger carriers were keen to increase their capacity on the Beijing and Shanghai routes, while cargo operators longed for being officially designated. In addition, more cargo operators from the Netherlands side wanted to be designated while Chinese airports such as Nanjing and Xiamen would like to see more fights with full 5th freedom traffic rights.

With no mounting pressure from either governments, special requests from airlines, airports or other stakeholders, discussions in November 2006 were held in a very constructive environment, with an arrangement agreed which further removed restrictions on market entry and capacity. Briefly, the total number of designated carriers for both sides was to be increased to 5, which could thus accommodate the requirements of Chinese cargo operators such as Jade Cargo and Great Wall. For passenger services, carriers of both sides were allowed to increase to a total of 33 frequencies from the previous 25. For Netherlands carriers, the maximum frequency for Amsterdam–Beijing route was 9 flights per week while Amsterdam-Shanghai was increased to 14 flights per week. For flights to other cities in China a maximum of 7 weekly flights was permitted. For cargo operations, a total of 25 frequencies were

allowed for both sides compared with the previous 14, but the Netherlands side could not increase their frequency to 7 on the Shanghai cargo route until 2008. The agreement also allowed 5th freedom traffic rights and codeshare arrangements between the designated carriers. Table 7.8 provides details of the agreements.

Table 7.8 Agreement reached in November 2006 for passenger and cargo operations.

Items	The Netherlands side	Chinese side
Number of designated carrier	5	5
Routes for passenger and weekly capacity	33 in total: 9 for Amsterdam-Beijing (phased in till 2008)	33 for Points in China and Amsterdam
	14 for Amsterdam-Shanghai (phased in till 2009)	
	10 in total for Amsterdam to other cities including Chengdu and Guangzhou	
Routes for cargo and weekly capacity	25 in total Amsterdam to points including Shanghai, Nanjing, Shenzhen, and Guangzhou; maximum 7 to each point	25 for points in China and Amsterdam

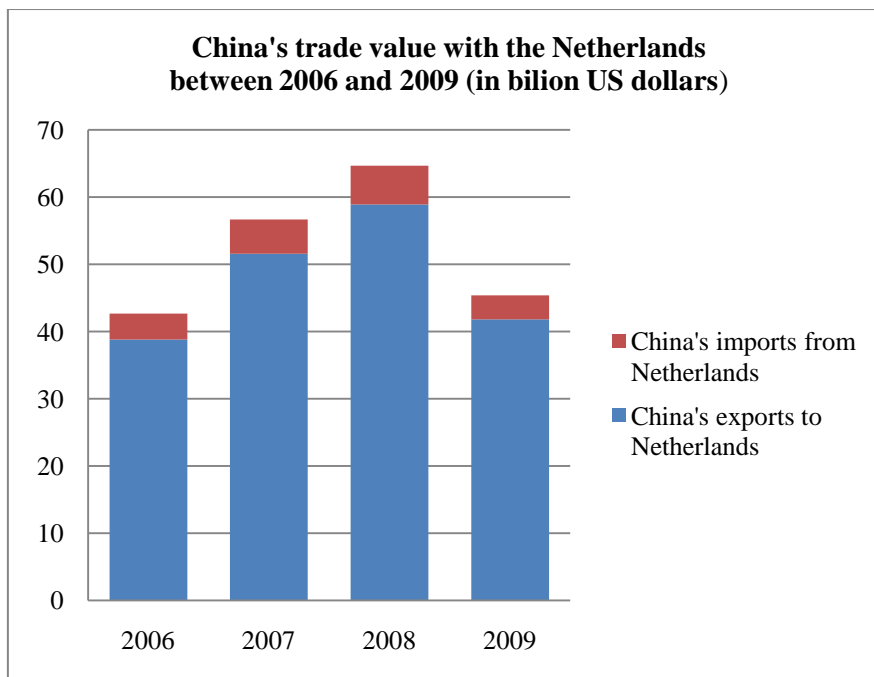
Source: adapted from the 2006 ASA

Compared with the agreement reached in 2003, the market entry restrictions were only relaxed modestly, with the Netherlands side being given more destination points in China, while the Chinese side being allowed to introduce 2 more cargo operators into the market. Passenger capacities were increased with 2 more frequencies to Beijing, and 4 more to Shanghai. For cargo operations, capacity was allowed almost 50 percent increase for each side, with 5th freedom traffic rights being permitted at immediate and beyond points. Codeshare arrangements were encouraged with third country carriers to enable the airlines to expand their network.

7.3.4.5 Latest consultation in March 2010

Since 2006, bilateral relations between the two countries have been further strengthened, with more frequent senior level visits and continuous strong growth of trade. According to China's MoC, in 2006, the trade between the two countries totalled \$42.7 billion, with China exporting \$38.8 billion worth of products. In 2008, the figure jumped to \$64.7 billion with \$58.9 billion of exports (Figure 7.7), with the Netherlands remaining the second largest trade partner for China in the EU, although the financial crisis had an impact on bilateral trade, causing a sharp drop to \$41.8 billion in 2009, a 18.4 percent decrease. In 2009, the Netherlands became the third largest source of investment recording \$790 million in China among the EU Member States in 2009, compared with \$865 million in 2006²⁰ (Wong, 2009).

Figure 7.7 China's trade value with the Netherlands between 2006 and 2009 (in billion US dollars).

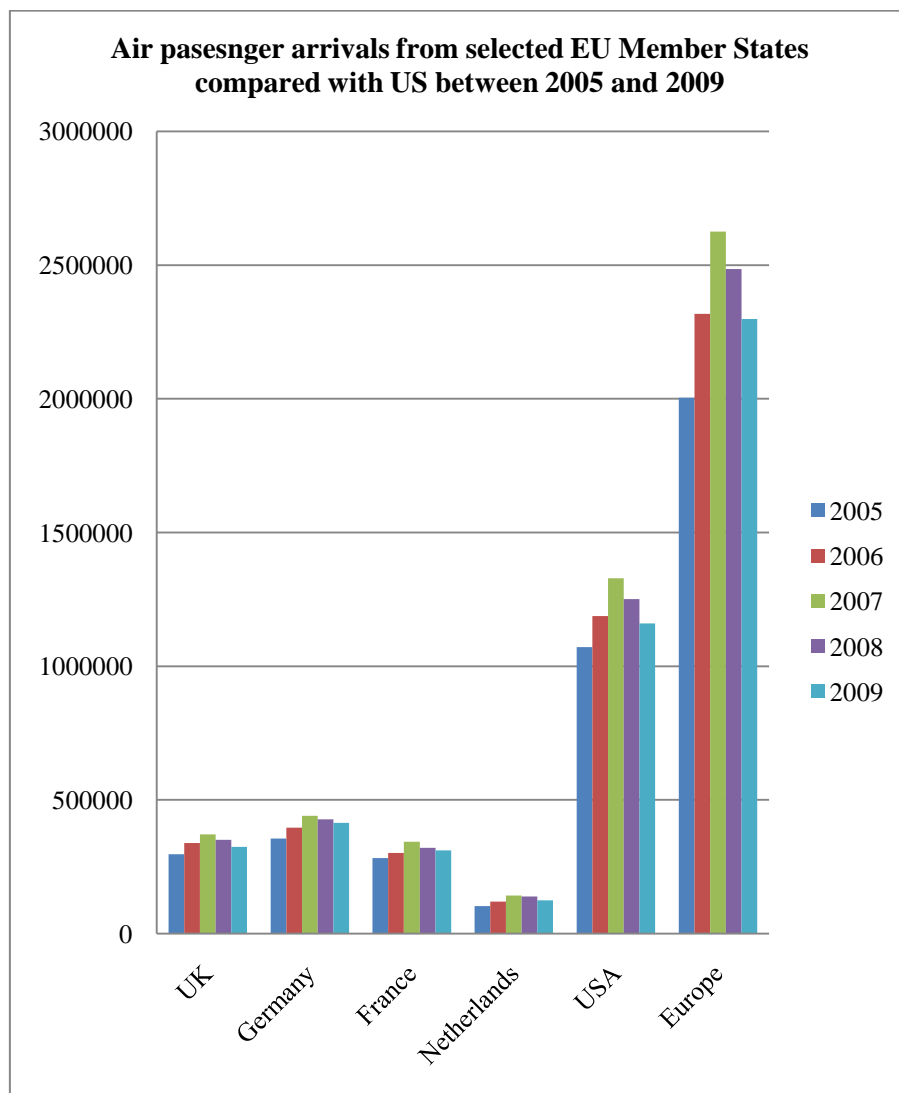


Source: Wong, 2009

²⁰ The Netherlands investment in China was \$617 million in 2007 and \$862 million in 2008.

The ADS of EU countries for Chinese tourists in 2003 stimulated China's outbound travel market to Europe, resulting in a remarkable rise in Chinese tourists to Europe. At the same time, arrivals from Europe including the Netherlands to China increased steadily. Data from CNTA showed that in 2005 about 4.78 million European visited China, among whom, 2 million arrived by air. In 2008, the figure rose to 6.1 million, with 2.48 million chose to fly to China, though the figure dropped to 4.6 million in 2009 due to the economic downturn. Figure 7.7 shows the arrivals of air passengers in China from the selected EU Member States compared with US between 2005 and 2009 (Figure 7.8).

Figure 7.8 Arrivals of air passengers from EU and selected Member States in China compared with the US between 2005 and 2009.



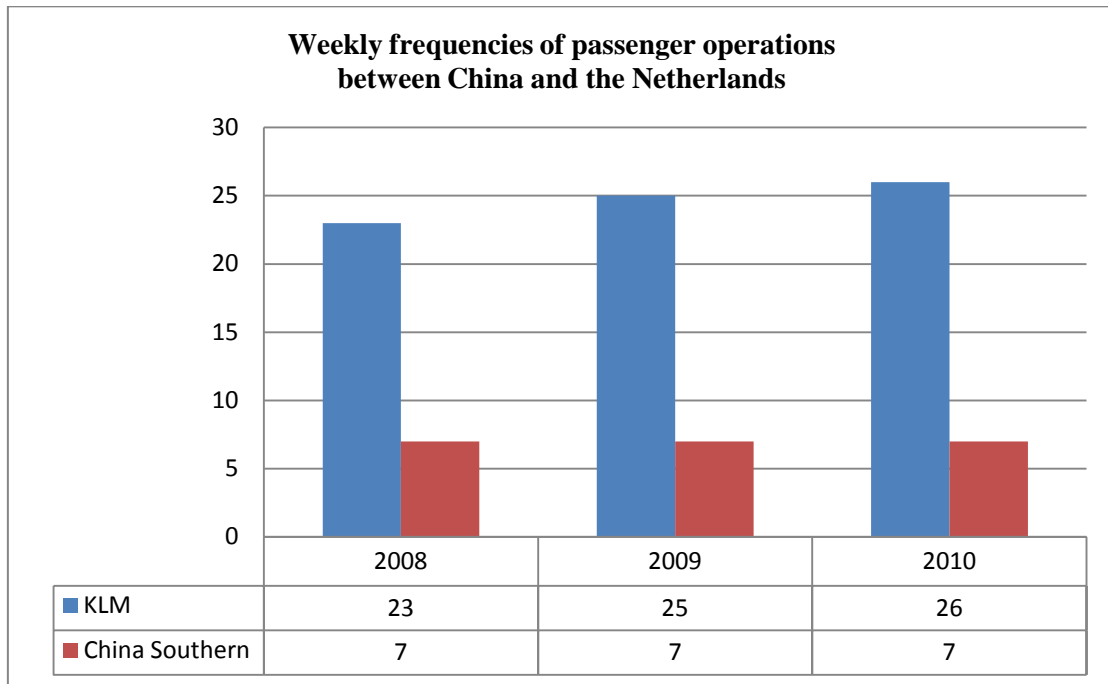
Source: www.cnta.gov.cn

The strong demand in both passenger and cargo market after 2006 inspired airlines to invest in the market to satisfy the demand. In terms of passenger market, soon after the 2006 consultations, both KLM and China Southern announced an increase of frequencies. In the winter/spring season of 2008, KLM was serving Beijing, Shanghai and Chengdu with 23 flights per week in total and codesharing with China Southern on 25 routes and Sichuan Airline on 6 routes (Rowland, 2010). “KLM was proud of being able to provide extensive services with such an extensive network within China with the support from its Chinese partners”, stated Mark Arxhoek in an interview with Shanghai Business Review (2009).

To effectively promote its services, KLM launched a branding campaign in 2008 which reflected its long-term strategy to generate more prospective high-level customers with initiatives including Chinese-speaking crew on board the flights, special Chinese menus, onboard Chinese-language magazines and Chinese-speaking staff at Amsterdam airport to help with Chinese speaking passengers. In particular, Club China has been launched for those who do business in China to share their experiences (Shanghai Business Review, 2009).

Compared with its counterpart, China Southern in 2007 operated 629 flights carrying 221,308 passengers with an average load factor of 72 percent. Although the number of flights and passengers dropped in 2008 and 2009 as a result of the financial crisis, overall market demand has remained high. Figure 7.9 compares the results of the two carriers.

Figure 7.9 Comparison of weekly frequencies of passenger operations between China and the Netherlands from 2008 to 2010.

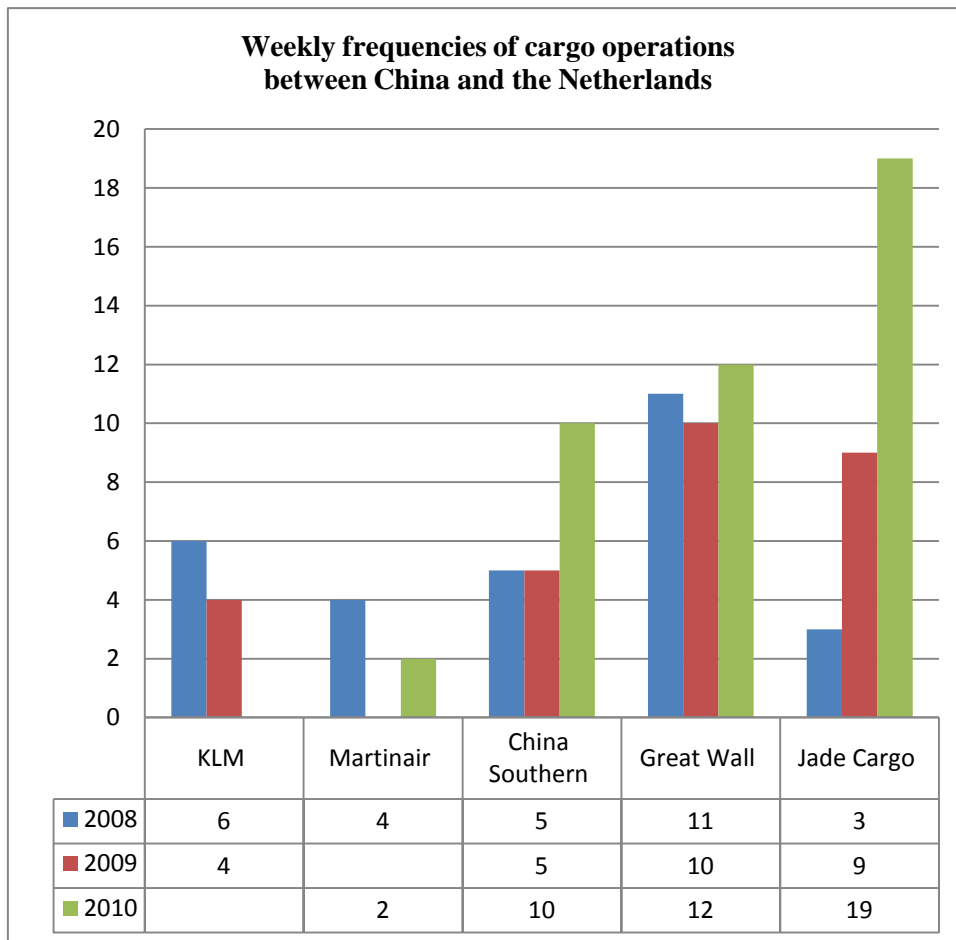


Source: www.caac.gov.cn

In terms of cargo, the two Chinese carriers, i.e. Jade Cargo and Great Wall, acted more efficiently. For new start-ups focusing on all-cargo international market, high-demand routes imply viable operations, robust business and profitability. The China-Netherlands market just fit best into the strategy of the two carriers. In 2007, Great Wall operated 11 weekly frequencies carrying 52,000 tonnes of freight while Jade Cargo operated 3 weekly frequencies carrying 25,000 tonnes of cargo (www.caac.gov.cn). Although the economic downturn affected their operations, Jade Cargo still managed to fly 9 weekly frequencies in 2009. Cargo volume had also been improved due to the utilisation of the 5th freedom traffic rights, which allowed the carriers to take traffic at intermediate/beyond points such as Dubai, Seoul and Stockholm. By 2010, Jade Cargo had increased its weekly frequency to 19 (compared with its initial 3 frequencies in 2007), ranking itself the third largest carrier in cargo operations in Amsterdam airport (Sweijen and Pouwels, 2010). Martinair was also able to operate to more Chinese secondary airports, which helped the carrier to expand its cargo network in the country.

Figure 7.10 compares the performance of all-cargo carriers in the Sino-Netherlands market from 2008 to 2010.

Figure 7.10 Comparison of weekly frequencies of cargo operations between China and the Netherlands from 2008 to 2010.



Source: www.caac.gov.cn

The continuous surge in market demand as well as the permission of the full 5th freedom traffic rights on intermediate and beyond points has attracted more potential Chinese carriers into the market. China Eastern wanted to be a designated carrier after joining SkyTeam while Yangtze River Express, the cargo arm of Hainan Airline group, also expressed its wish for prospective operations in the near future. From the Netherlands' perspective, KLM, seeing the benefits of flying to Chengdu, was very keen to expand its network to more secondary Chinese airports and have, thus, chosen Hangzhou, the

capital city of Zhejiang Province 100 kilometres south to Shanghai, for a prospective direct service.

With the above in mind, the latest round of discussions between the two countries was held in March 2010. With a view of providing as many commercial opportunities as possible for their businesses, the two authorities agreed to further remove the restrictions in terms of market entry and capacity permitting 68 weekly frequencies in total for each side split proportionally between passenger and cargo operations. In addition, both sides agreed to amend the designation clause, i.e. the Chinese side accepted Community carrier, though with terms and conditions attached, which had been discussed between the two parties over the last couple of consultations without any success. Table 7.9 provides a summary of the agreement.

Table 7.9 Summary of the agreement in 2010 for passenger and cargo operations.

Items	Chinese side	The Netherlands side
Passenger routes and weekly capacity	33 in total, for points in China to the Netherlands	14 for Amsterdam-Beijing
		14 for Amsterdam-Shanghai
		15 for Amsterdam to other points including Chengdu and Hangzhou,
Number of designated passenger carriers	2	2 (EU standard clause with respect to Community carrier with terms and conditions)
Cargo routes and weekly capacity	35 for cargo, but allows up to 49 including 14 out of the 33 passenger frequencies.	35 in total for Amsterdam to points including Shanghai, Nanjing, Shenzhen, Guangzhou and Hangzhou
Number of designated cargo carriers	2	2 (EU standard clause with respect to Community carrier accepted with terms and conditions)

Source: adapted from the 2010 ASA

7.3.5 Summary

Although China and the Netherlands only started their air transport relationship in 1996, it has developed smoothly and rapidly over the last fifteen years. Restrictions on market entry, capacity and other business issues have been removed gradually, resulting in a more relaxed operational environment for carriers of both sides to explore the market opportunities (from one carrier for each side with 2 weekly frequencies to 4 carriers for each side with 68 weekly frequencies). Destinations of services have increased from one city in each country to numerous cities, with several intermediate and beyond points and full 5th freedom traffic rights. Codeshare arrangements are permitted between both designated and non-designated carriers which have enabled the airlines to expand their services to offer a more coherent network connection. This progressive relaxation of restrictions on operations allowed the airlines to adapt their strategies and operations to meet the market demand, while at the same time enhancing the commercial and business links between the two countries.

7.4 China and the United Kingdom (UK)

7.4.1 UK and its air transport industry

As a contracting state to ICAO and the Party that concluded Bermuda I and II bilateral ASAs with the US, which have significantly shaped the global air transport industry over the last six decades, the UK has played a pivotal role in that process. Although a small island off the European continent 35 kilometres away from France at the nearest point with a population of 62 million in 2009, the UK is arguably the most important air transport hub in Europe if not the world (www.iata.co.uk). “It thinks, breathes and lives flying, with air travel being in the British blood”, claimed Godden (2009). Over the years, the passion for travel in search of international business opportunities and more sun has stimulated the rapid growth of the nation’s air transport industry. In 1971, the British made around 6.7 million holiday trips abroad while in 2005 they made 66.4 million holiday overseas trips, almost a ten times increase year on year. Of these, 43 million trips were made by air, compared with 10 million by sea.

The public enthusiasm for air transport has stimulated the British airlines to strive to remain competitive in order to grow and prosper. By the end of 2009, the UK hosted more than 30 airlines, with British Airways (BA) and Virgin Atlantic Airways (VG) (hereinafter referred to as Virgin) being world-renowned network carriers focusing on long-haul international routes while easyJet and Flybe are innovative LCCs concentrating on intra-European markets. As a whole, the industry carried over 235 million passengers and over 2.3 million tonnes of freight in 2009 (www.dft.gov.uk).

With a history of 91 years (Clark, 2010), BA has experienced its cheerful and tough times. The airline has been recognised as the most successful airline tagged with “the world’s favourite airline” brand in what is at heart a commodity business where identical aircraft flies to identical destinations at identical speeds (Hilton, 2005). BA has created a premium product in a commoditised world and helped make the world’s favourite airline among the world’s most profitable. Since the early 1990s when Lord King launched a radical shuffle of the airline, it has remained a brand of success.

However, the years of success since 1980’s merger that created BA seemed to draw to a close in the twenty-first century. BA has made a loss in its operations and has been struggling with its finance over the last two to three years. Since 2008, BA has experienced a radical overhaul of its corporate structure and operation shedding thousands of jobs with an attempt of turning around for profit. Rows with unions, catering companies made its operations worse.

Despite of the operational loss, strike and refusal of anti-trust immunity, the carrier remained to be one of the most competitive airlines in the world through privatisation, various mergers and consolidation since the 1980s. Focusing on high-yield business travellers, BA was able to remain as one of the top 10 world airlines over the last few decades. It was ranked ninth in terms of both passengers carried and revenues made in 2009, recording 31.8 million passengers, realising 110.9 billion RPK and \$12.8 billion revenues. However, this was less than half when compared with Lufthansa (after taking over Swiss International, Austria Airlines and British Midlands Airways (BMI)) which registered \$31.0 billion revenues taking the top position of the league and Air France-KLM with \$29.7 billion in second place, both of which are European-based network

carriers competing with BA on a global scale. The standalone situation was reversed in November 2010 when the proposed merger of BA with Iberia, Madrid-based Spanish legacy carrier, was approved by their shareholders. The merger will create another big international airlines group identical to Lufthansa and Air France-KLM, bringing the total number of aircraft in the fleet to 400²¹ serving more than 250 destinations with 57,000 employees. The merger will enable BA to strengthen its position in the market across the Atlantic and, in particular, explore more opportunities in Latin America where it has been under-represented (Milmo 2010).

BA is one of the two designated carriers operating between the UK and China. It inaugurated its twice weekly London-Beijing service in 1980 and expanded to Shanghai with 5 weekly frequencies in June 2005. Currently the carrier operates 7 weekly frequencies to Beijing competing with Air China and 6 weekly frequencies to Shanghai against Virgin. In addition, BA operates to Hong Kong with 14 weekly frequencies.

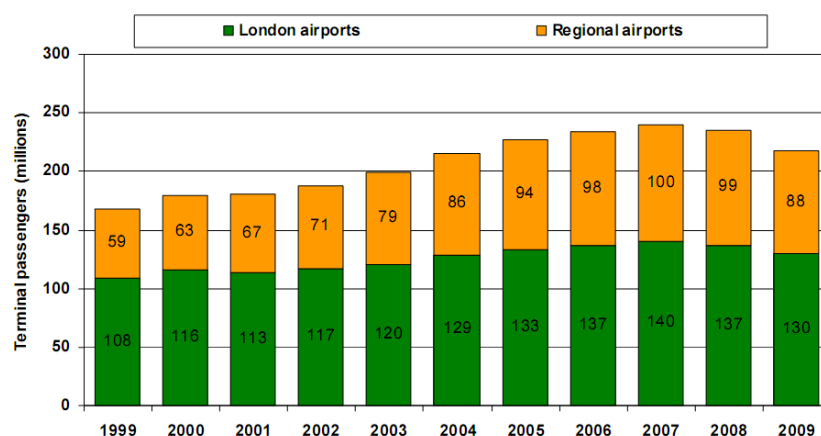
Virgin was only launched in 1984 by Sir Richard Branson who established the Virgin brand through Virgin Records. Being committed to becoming a high quality and value-for-money airline, Virgin has since grown rapidly offering scheduled services to 30 destinations around the world (www.virgin-atlantic.com). With a 49 percent stake held by Singapore Airlines, Virgin operates through code-sharing arrangements with numerous carriers including Continental Airlines, Singapore Airlines, Virgin Blue and BMI, independent of any global alliances. With only 36 aircraft compared with BA's 233, Virgin has been a strong competitor with BA on all long-haul routes where BA has established. The trick for Virgin to remain competitive is to present passengers with an unrivalled in-flight and airport experience such as limousine pick-ups and drive-through check-in, spa at the airport lounge, in-flight massaging, manicures and seat-back monitors, which highlight the travel experience for passengers (Blitz, 2007). The carrier started its Shanghai service out of London Heathrow with a 2 weekly frequencies in 1999 and has expanded to a daily service, competing with China Eastern and BA on the same route.

²¹ BA had 233 aircraft in the fleet in 2009.

The UK has 56 airports with scheduled air services, with the main municipal airports being distributed in pairs typically separated by about 70 kilometres (Humphreys, 1999). Such a dense infrastructure provides the majority of the UK population with access to at least 2 airports within one and a half hours' drive time from their home, making air travel a very accessible transport mode for the British people. For example, in 2001, at least 50 percent of the UK population flew at least once. In addition to domestic traffic, the UK is particularly attractive to international passengers thanks to its convenient and extensive connecting network capabilities. The UK CAA's data revealed that of the 218 million passengers handled by all UK airports in 2009, some 176.4 million were international passengers, representing 81 percent of the total.

The 5 London airports, comprising Heathrow, Gatwick, Stansted, Luton and City Airport, usually handle 60 percent of all terminal passengers, with the rest going to regional airports. However, regional airports have enjoyed a faster growth in terms of passenger traffic between 1999 and 2009 (Figure 7.11), with terminal passenger numbers increasing by 48 percent, compared with 20 percent at the five London airports. For example, in 1970, all UK airports only handled 32 million passengers. The figure went up to 102 million in 1990 and jumped to 240 million in 2007.

Figure 7.11 Number of terminal passengers at London and UK regional airports from 1999 to 2009.



Source: DfT UK, 2009

Heathrow Airport is a well established international schedule service airport for the UK (Humphreys, 1999). Being the home base for BA, Virgin and BMI as well as the European hub for the Oneworld Alliance, Heathrow handled 65.9 million passengers in 2009, taking the second place in the top 10 busiest airports in terms of passenger throughput, just after Atlanta, which recorded 88 million. Of its total traffic, 92 percent (60.6 million) were international passengers, making it the world number one airport in terms of international traffic, followed by Charles de Gaulle (53 million) and Hong Kong (45 million). In 2009, Heathrow hosted 88 airlines connecting 185 cities with New York, Dubai, Dublin, Amsterdam and Hong Kong being the top 5 most popular destinations.

7.4.2 The Government agency responsible for international air transport and bilateral negotiations

The UK DfT is the government agency responsible for formulating international air transport policies. Reporting to the Department's Director General of Civil Aviation, the International Aviation, Safety and Environment Division (IASSED) is responsible for the day-to-day management of bilateral aviation relations between the UK and its counterparts, which involves negotiating new bilateral arrangements and any amendments thereto, and enforcing existing bilateral arrangements. The Division is also responsible for representing the UK's interests in EU level negotiations (www.dft.gov.uk).

In addition to the DfT, the UK Civil Aviation Authority (CAA) is the most important agency especially with respect to the nation's international air transport. It is the UK's independent specialist aviation regulator covering economic aspects, safety and consumer protection. The Economic Policy and Strategy team in the Economic Regulation Group works closely with colleagues in other sections to develop and support the activities relating to a wide range of aviation issues. The Economic Policy and International Aviation team provides policy analysis and advice to the DfT on liberalisation and competition issues in the airline industry. This includes contributing to the development of EU aviation agreements, to negotiations on bilateral ASAs, conducting economic studies and providing data and advice to UK competition

authorities (specifically the Office of Fair Trading and the Competition Commission) with respect to airline and airport competition cases.

The team also plays a key role in cases involving the allocation of scarce traffic rights between competing UK airlines. This kind of situation arises where more than one UK airline seeks to operate services between the UK and a country outside the European Common Aviation Area, while the bilateral air services agreement with that country restricts the number (or nature) of services that can be operated, or the number of carriers that can fly.

With the support of the CAA, the DfT has developed a mechanism which facilitates its formulation of negotiation strategies and tactics. This involves consultations with airlines, airports and other stakeholders regularly, in particular before any bilateral talks, to ensure that the UK's interests are properly and effectively represented and protected in the negotiations (Coles, 2010; Knight, 2010; Humphreys, 2010).

7.4.3 The UK Government's view towards international air transport

Believing that the optimum allocation of resources of the common goods of society would be best served by a free market economy based on the pursuit of self-interest and guided by competition (Weber, 1947), the UK has led the way with its privatisation programme which has influenced economic policy throughout the world (Bishop et al, 1994). The full effects of privatisation can only be realised within a deregulated market structure where effective competition can flourish (Humphreys, 1999).

With respect to the air transport industry, the government believed that “the interests of users will be best served if airlines are free to operate air services in competition with one another according to their commercial judgement, subject only to the application of normal competition policy. A liberalised market structure and reliance to the greatest extent possible on competition rather than regulation is the best way of delivering efficient aviation services and consumer benefits, which could only be achieved through the removal of all government-imposed restrictions on the commercial behaviour of airlines, putting aviation on the same footing as other industries. To this end, it is believed that the long term interests of users would be best served by a full liberalisation

of international aviation markets, involving the removal of all bilateral restrictions so that the airline industry can compete in the same playing level (UK CAA, 2008).

Such a liberalised view towards air transport has enabled the UK government to play an active role in promoting the liberalisation of air transport both domestically and internationally. The idea of transforming its domestic airline industry was first initiated in 1967 with the release of the Edwards report, which argued that the airline industry should be regarded as a commercial enterprise. Its purpose should be to see that each customer gets what he wants, not what somebody else thinks he might want, at the minimum economic price that can be contrived (Staniland, 2003). The regulatory change affecting the airlines occurred in 1979 under the Thatcher Administration, which was determined to transform Britain from a mixed economy to a market economy. Although the process of consolidating the national carrier, BA, had not been completed until 1987, it was still well ahead of the restructuring and privatisation of Air France and Lufthansa which only took place in the mid-1990s (Staniland, 2003). By passing the Airports Act in 1986, the government also privatised its airport sector and transformed all of its municipal airports into commercial companies with an objective of encouraging enterprise and efficiency in the operation of major airports to allow the introduction of private capital rather than being subsidised by taxpayers or ratepayers.

Over the years, the UK government has been working persistently in pursuing liberalised bilateral arrangements with its counterparts in order to eliminate all unnecessary restrictions to create a pro-competitive environment for the UK airlines to operate at its free will to increase the benefits of consumers (www.dft.gov.uk). By November 2010, the UK had concluded more than 150 bilateral ASAs. Among them, 4 are regarded as “truly liberalised arrangements with unlimited 3rd, 4th, 5th, 6th, 8th and 9th traffic rights, (including cabotage), without any restrictions on the points that can be served in either country. In some cases the traditional ownership and control/nationality requirements have been liberalised too” (Knight, 2010). Another 27 are considered “open ASAs/bilateral relationships, which means there are no restrictions on the number of 3rd and 4th traffic rights that can be operated between the two countries, nor any restrictions on the points that can be served in either country. Although the majority of

these arrangements have limited 5th and 6th traffic rights, quite a few do have unlimited 5th and 6th traffic rights such as those with the US and Canada” (Knight, 2010).

7.4.4 Bilateral air transport relations with China

The first China-UK bilateral ASA was signed in November 1979 with immediate effect. Ever since then, more than 10 rounds of discussions have been conducted with the latest being held in February 2004. Due to historical reasons, China-UK air transport relations used to include the element of Hong Kong, covering the arrangements between mainland China and Hong Kong and the beyond points as well as mainland China and the UK. In order to keep in line with the main objectives of the research, the mainland China-Hong Kong arrangements will be excluded from this research with only the mainland China-UK arrangements being examined and discussed.

7.4.4.1 Negotiations before 1997

Like any other bilateral ASAs in the 1970s when the global airline industry was heavily regulated, the China-UK agreement was not an exception. By nature it was a very restrictive one, with the intention of either government being to protect its own carriers. The air link between the two countries carries more of a political implication than an economic and trade significance. The arrangements allowed both sides to designate one carrier to operate 2 weekly frequencies between the capital cities, namely Beijing and London respectively, with a couple of intermediate points en route the South Asia, the Middle East and Europe due to the technical capabilities of the aircraft in those days (Table 7.10).

Table 7.10 Key points in the 1979 Agreement.

Items	Chinese side	The UK side
Number of designated carriers	1	1
Weekly capacity	2	2
Passenger and cargo routes	Beijing-intermediate points-Frankfurt-London	London-intermediate points-Beijing

Source: adapted from the 1979 ASA

The carriers of both sides soon launched their 2 weekly services respectively with BA and CAAC (changed to Air China in 1985) in November 1980, though BA flew out of its Heathrow home base while CAAC landed at Gatwick (moved to Heathrow in the late 1980s). Due to the small volume of bilateral trade and few people exchanges, the market demand had remained weak over the following two decades, resulting in little or no desire of both parties to expand the services. Although negotiations were held respectively in 1985, 1990, 1991 and 1994, they mainly focused on the revision of the performance of the carriers rather than the removal of restrictions. The consultations held in 1991 and 1994 were primarily devoted to the arrangements between mainland China and Hong Kong and the beyond points for the expansion of air links.

The situation remained unchanged until June 1996, one year before the handover of sovereignty of Hong Kong to the Chinese government. The agreement reached then allowed both parties to increase to a third and fourth weekly frequency from 1996 and 1997 respectively (Table 7.11) and was the first relaxation of the restrictions on operations since 1979, almost 18 years since the ASA became effective. The 1996 arrangement also amended the route schedules allowing the Chinese carriers to overstop at Hong Kong enroute to London with full traffic rights.

Table 7.11 Agreement between China and the UK in 1996.

Items	Chinese side	The UK side
Number of designated carriers	1	1
Route	Beijing-Hong Kong-London	London-Beijing
Weekly capacity	3 as of winter 1996	3 as of winter 1996
	4 as of summer 1997	4 as of summer 1997
Remarks: The Chinese side was allowed to operate Beijing-Hong Kong-London with a maximum of 4 weekly frequencies with full traffic rights. However, an overstop at Hong Kong was only allowed one way. Capacity was included in the total entitlement.		

Source: adapted from the China-UK 1996 Agreement

7.4.4.2 Negotiations after 1997

The year 1997 carries great significance in the bilateral relations between China and the UK. In this year, the sovereignty of Hong Kong was passed back to the Chinese government, which meant that the central government in Beijing was able to exercise its jurisdiction over Hong Kong on its dealings with the international community although the Hong Kong SAR has the authority to conclude any bilateral treaties with the approval of the central government.

As of 1st July 1997, all arrangements agreed between China and the UK with respect to mainland China-Hong Kong and beyond points, except Beijing-Hong Kong-London arrangements, were no longer an integral part of the Sino-UK package, but rather the special arrangements between the Chinese government and the Hong Kong SAR authority (Hong Kong Basic Law, Article 132-133²², 1990). The separation of the element of Hong Kong enabled both governments to concentrate on the country-pair markets in the discussions held respectively in 1998 and 2004 and to consider how to expand the bilateral trade that had started to pick up in the middle of the 1990s.

7.4.4.2.1 Discussions in 1998

²² **Article 132:** All air service agreements providing air services between other parts of the People's Republic of China and other states and regions with stops at the Hong Kong Special Administrative Region and air services between the Hong Kong Special Administrative Region and other states and regions with stops at other parts of the People's Republic of China shall be concluded by the Central People's Government.

Article 133: Acting under specific authorizations from the Central People's Government, the Government of the Hong Kong Special Administrative Region may:

- (1) renew or amend air service agreements and arrangements previously in force;
- (2) negotiate and conclude new air service agreements providing routes for airlines incorporated in the Hong Kong Special Administrative Region and having their principal place of business in Hong Kong and providing rights for over-flights and technical stops; and
- (3) negotiate and conclude provisional arrangements with foreign states or regions with which no air service agreements have been concluded.

The arrangements reached in 1996 enabled carriers of both sides to increase their weekly frequencies. Both BA and Air China started their third weekly services from the winter season of 1996. By 1998, BA had operated 4 weekly frequencies on the London-Beijing route while Air China remained at 3 weekly services.

The financial crisis in Southeast Asia in 1997 had a significant impact on Chinese carriers, resulting in a weak demand for international air transport in the Southeast Asia market. However, it did not discourage Sino-UK officials from scheduling a discussion in October 1998, co-incidentally the time when the then British Prime Minister Tony Blair paid a visit to China. Both parties agreed that frequencies on the Beijing-London route should be increased from the current 4 weekly to 5 as of summer 1999 and 6 as of summer 2000. The British side was very keen to have Shanghai as a second destination in mainland China and would want a second carrier to be eligible to operate in the market. The two thus agreed a deal allowing two carriers from each side in the market and Shanghai being included as a second point of call for the UK carriers with 2 weekly frequencies as of summer 1998 and up to 4 weekly frequencies as of summer 2000.

The new traffic rights available, unfortunately, could not satisfy the appetite of the UK carriers, with both BA and Virgin wishing to exercise the country's full entitlements of the 2 weekly services to Shanghai. In order to decide whether to award the two airlines one weekly frequency each or award both frequencies to one of the airlines (CAA, 1998), the UK CAA convened an open hearing with relevant stakeholders being present.

Believing that Shanghai was one of a small group of cities with exceptional commercial potential in the coming decades for international business in general and air travel in particular (CAA, 1998), both BA and Virgin presented a strong case with an attempt to convince the CAA that each was more appropriate than the other for the new operation. BA, already operating to Beijing 4 times per week, stated that the decision as to which airline should fly to Shanghai should be made primarily on the basis of the reasonable interests of users, with further weight given to the need to facilitate competition by British airlines with other airlines rather than competition between British airlines, with consideration being given to securing the sound development of the industry and to the

economic prospects of the services. Virgin, on the other hand, argued that the award to Virgin would be consistent with the Authority's policy to ensure active competition between British airlines while at the same time benefiting the travellers by giving them a second choice to fly into mainland China (CAA, 1998).

After listening to the arguments from both BA and Virgin as well as user group representatives, the CAA decided to award the 2 weekly Shanghai services to Virgin rather than BA, being convinced that competition in the UK industry and in the UK/China market was likely to be strengthened to a greater degree with the entry into the market of Virgin (CAA, 1998).

Virgin, thus, became the second carrier in the UK-China market in February 1999 and inaugurated its London-Shanghai services in May. For Virgin, the Shanghai right was symbolic and significant, which meant that it was able to compete with capacity on international long-haul routes where BA had not been established (Humphreys, 2010). BA, on the other hand, did not give up its ambition to expand its services to Shanghai. It lodged another application to CAA in 1999 for the other 2 weekly frequencies that became available from summer 2000. However, another open hearing in November 1999 convened by CAA, to BA's disappointment, did not bring its anticipated traffic rights to Shanghai. Instead, they went to Virgin again, thus bringing its operations to Shanghai to 4 weekly frequencies (Humphreys, 2010).

For the Chinese side, the allocation of the traffic rights with respect to Shanghai seemed to be an easy game as only China Eastern expressed a wish to become the second carrier in the China-UK market. The airline, though receiving the approval for a Shanghai-London service shortly after the negotiations, failed to launch the flight until 2003, almost 4 years later than its British counterpart.

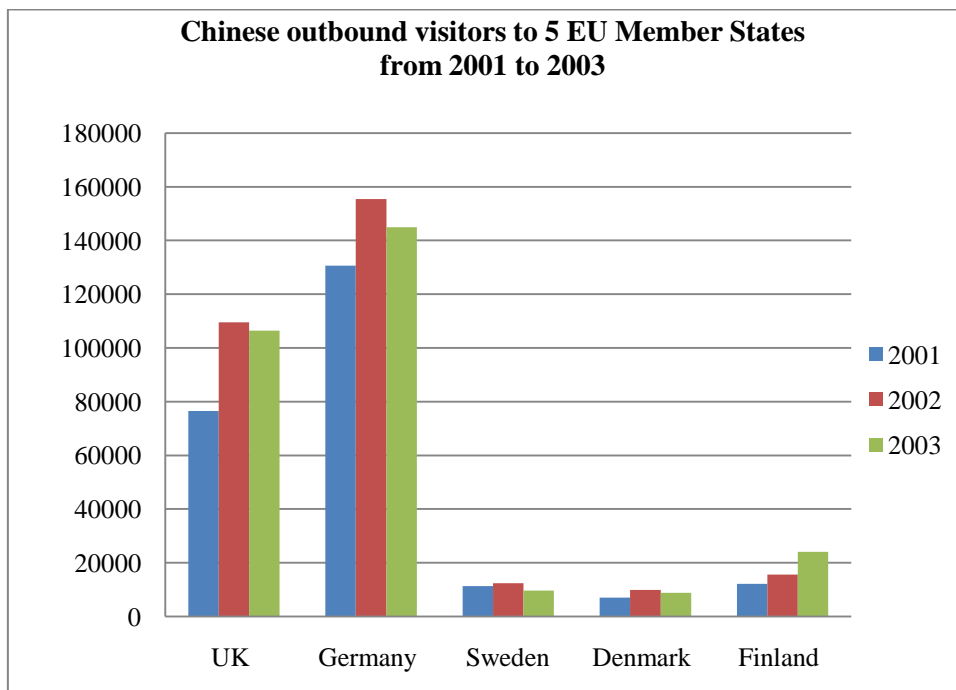
7.4.4.2.2 Consultation in 2004

Following the discussions in 1998, bilateral trade between China and the UK had picked up rapidly. The exchange of visits of senior officials further inspired economic and trade activities between the two countries. Following the successful visit of Tony Blair to China in October 1998, Chinese President Jiang Zemin paid his first visit to the UK in

1999 and launched a China-UK Forum, with an aim of enhancing the bilateral relationship to a comprehensive partnership. In 2001, the trade value between the two countries had surged to \$10.3 billion, a 4.1 percent increase over that in 2000. Before 2003, the UK had remained China's second largest trade partner of the EU Member States though later was replaced by the Netherlands.

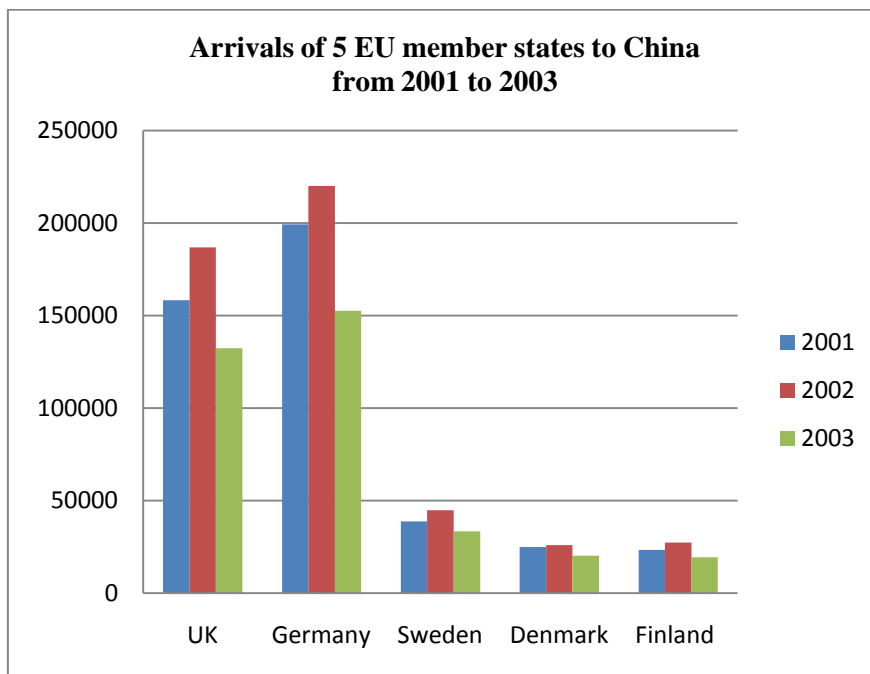
Passenger traffic increased rapidly after 1997. According to CNTA, the UK recorded 302,500 arrivals in China in 2001, overtaking Germany and France. This compared with 227,900 in 1997, representing an average 7 percent increase year on year. On the other hand, Chinese visitors to the UK had increased remarkably recording 88,000 in 2001, 40.2 percent increase over the previous year. In particular, the UK became the second largest destination for Chinese students in the early 2000s just after the US, with tens of thousands flocking to the country each year. Figure 7.12 and 7.13 summarise the air passenger traffic between China and the UK between 2001 and 2003, compared with other major western countries in Europe, which reveal that Chinese outbound visits to the UK enjoyed the most rapid growth during the period compared with the UK arrivals in China.

Figure 7.12 Chinese outbound visits to 5 EU Member States between 2001 and 2003.



Source: CNTA

Figure 7.13 Arrivals from 5 EU Member States to China between 2001 and 2003.

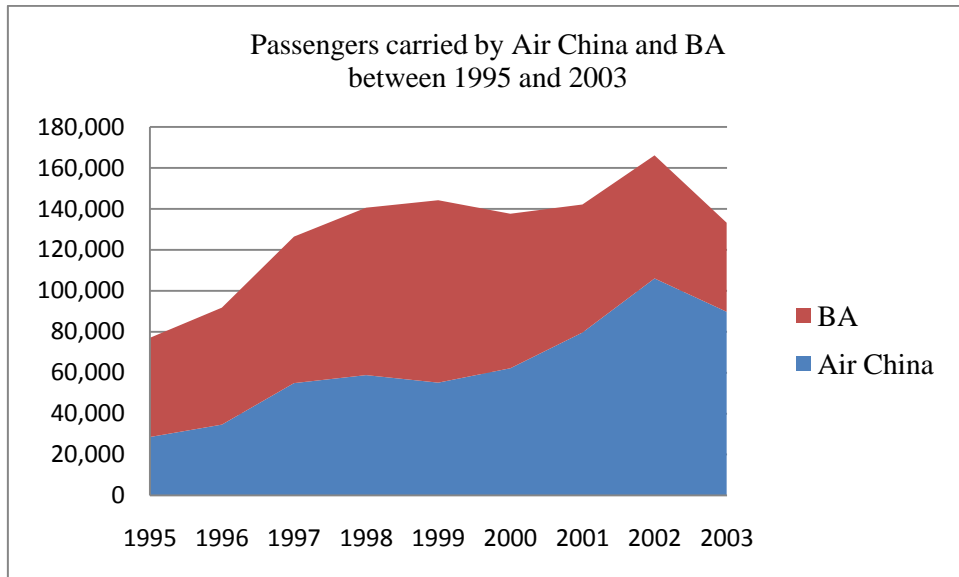


Source: www.cnta.gov.cn

The booming of bilateral trade and passenger traffic encouraged both parties to increase their services. In the winter season 2003, Air China was operating 5 weekly services between Beijing and London compared with BA's 3 weekly services on the same route. Virgin flew 4 weekly services between London and Shanghai, while China Eastern inaugurated 3 weekly services in the summer season of 2003. Compared with the entitlements agreed in the 1998 arrangements, 5 out of 6 of the Beijing-London route frequencies were used by Air China, while BA only used half of its traffic rights. For the Shanghai-London route, Virgin had used up all of its 4 weekly entitlements while China Eastern only used up 75 percent of its entitlement. The effective use of capacity was also reflected in the number of passengers carried, which had seen a steady growth over the years (Figure 7.14). Apparently, since 2001, Air China had both provided more flights and carried more passengers than BA to and from Beijing, although BA carried

more business passengers which made up 65 percent of its total traffic compared with 19 percent for Air China²³ (CAA, 2007).

Figure 7.14 traffic carried by Air China and BA between 1995 and 2003.



Source: CAA, 2007

The high demand and satisfactory performance inspired both parties to seek more traffic rights. Air China saw significant potential in the Sino-UK market and requested a daily service on the Beijing-London route as well as an entry into the Shanghai market, quoting the magnificent increase of passenger numbers boarding its aircraft with more than 70 percent load factors on average between 2001 and 2004 (except a certain period in 2003 due to the effect of SARS). China Eastern, though recently joining the competition with Virgin on the London-Shanghai route, was also very optimistic about the continuous high demand in the market and wanted to enter the Beijing-London market, though it was quite conservative about cargo operations. In addition to the requests from incumbents, the market attracted more Chinese carriers, such as China Southern, Hainan Airlines, Shanghai Airlines and China Cargo, who were all keen to become designated carriers on the Sino-UK market.

²³ CAA airport statistics, reduced by 6 percent to take account of non-revenue passengers (CAA, 2007)

The requests of the Chinese side were echoed by their British counterparts. The UK proposed to separate the operations of passenger and cargo services and remove the restrictions on the numbers of designated carriers with capacities being increased. In addition, the British delegation wished to amend the designation clause in the existing ASA in order to bring it to conformity with the EU law. With identical requests and confidence in the prospective market growth, the 2004 consultation went smoothly with an agreement reached to both parties' satisfaction (Table 7.12).

Table 7.12 Arrangements agreed between the two parties in 2004.

Items	Agreement
Routes for passenger and cargo	Separation of passenger and cargo operations
Number of Designated carriers	No restrictions for both side
Capacity for both sides	2004: 20 weekly frequencies 2005: 31 weekly frequencies 2006: 38 weekly frequencies
5 th freedom traffic rights	Selected intermediate and beyond points with full 5 th freedom traffic rights

Source: adapted from the 2004 ASA

Compared with the agreement of 1998, the 2004 arrangements were a big step forward in terms of relaxing the restrictions on the operations. The number of designated carriers was completely relaxed from 2 for each side to unlimited. The capacity was increased from 10 weekly for each side (6 for Beijing and 4 for Shanghai) to 20 weekly in 2004 and 38 in 2006, which was almost a four times increase. In 1998, there was no specification on cargo operations, which were treated as part of passenger services, while in 2004, cargo operations became independent from passenger operations with no restrictions on capacity.

The agreement enabled BA to increase its operations to 5 frequencies to Beijing while at the same time to enter into the Shanghai market, which it started in June 2005 that it had longed for since 1998. Virgin was able to invest more in its well-established Shanghai market to increase its services to a daily operation. For the Chinese side, Air China was allowed to increase its frequencies to London with its cargo arm starting all-freight

services to Manchester. China Southern was awarded traffic rights to the UK, though it has had no specific date to launch the service yet. Table 7.13 shows the traffic between London Heathrow and Beijing in the first eight months of 2004²⁴.

Table 7.13 Heathrow-Beijing scheduled services the first eight months in 2004.

	Point to point passenger	Flights	Total passengers	Seats	Seat factor (%)
Air China	108,979	561	108,979	170,406	64
BA	73,697	384	73,697	146,136	50
Total	182,676	945	182,676	316,542	58

Source: CAA, 2007

7.4.4.3 Prospective discussions scheduled for April 2011

It has been 6 years since the last round of discussions held in 2004 between the two parties, during which period of time, international air transport has experienced ups and downs. Until 2007, the international air transport had seen magnificent increase of demand, with a historical record of revenue passengers carried, but was then followed by an unprecedented economic downturn which hit the global airlines severely in 2008 and 2009. Before the industry was able to recover, the epidemic of swine flu across the Americas and the volcanic ash in Europe gave the industry another blow, with traffic plummeting on a global scale. LCCs started to spread to Asia including China with air travel becoming an affordable transport mode for the public.

In terms of the general regulatory environment, the EU and the US had concluded their second stage Open Skies agreement to create an OAA, enabling all EU established carriers to operate services from any points in the EU to any points in the US. At bilateral level, the UK has concluded quite a few Open Skies agreements with other countries including India, Singapore, Canada, Australia and New Zealand, which consequently stimulated a significant growth in its international air transport market. A UK CAA study conducted in July 2007 on UK's long haul air transport market

²⁴ CAA airport statistics reduced by 6 percent to take account of non-revenue passengers (CAA, 2007).

(excluding the EU market) revealed that Open Skies agreement covered about 60 percent of traffic (UK CAA, 2007), which have significantly stimulated the traffic growth. British airlines have taken advantage of such relaxed regulatory environment, with BA having launched a subsidiary Open Skies in Paris for direct cross-Atlantic services. BA itself has merged with Iberia to form another giant carrier in Europe and its alliance arrangements with American Airlines have received anti-trust immunity from the US DoT.

From China's perspective, the Chinese government gained more experience in negotiating liberalised agreements with its counterparts, especially with a handful of EU Member States, and have accepted the establishment and nationality clause and removed constraints on cargo operations and 5th freedom traffic rights for passenger services. Chinese airlines have grown rapidly with more traffic carried and revenues improved. Air China has become a Star Alliance member while both China Eastern and Southern are with SkyTeam.

Bilateral trade has grown remarkably, with more passengers travelling between the two countries. Figures from CNTA showed that British inbound travellers to China increased from 500,000 in 2005 to 551,500 in 2008, though dropped to 528,800 in 2009 due to the economic downturn. However, China was still ranked 39th long haul country destinations from London Heathrow airports in 2008 according to a recent research report, though Hong Kong SAR taking the 19th place recording 1.55 million English arrivals from London Heathrow (RDC aviation, 2010).

Although both parties had intended to resume discussions earlier, they failed to materialise it due to various unanticipated reasons. The good news is that after some communications, both have committed to a meeting in April 2011 to resume the discussions. Looking to the forthcoming consultation, the UK side was very confident that more relaxed arrangements would be agreed so as to promote its economic growth at regional airports (Knight, 2010). They also hope to resolve the slot issue in major Chinese airports so as to allow UK carriers to serve the market more efficiently. The UK is also interested in some arrangements with respect to the traffic between Hong Kong and Taiwan so as to allow its carriers to grow in this market. They hoped that the

designation clause would be agreed by the Chinese side so that it will fulfil its obligations as an EU Member State. The Chinese side hoped that slots could be available at Heathrow airport to allow Chinese carriers to compete and bring more traffic and was ready to discuss the designation clause. Although there is still quite some time to go before the consultation, both sides are optimistic and confident about the positive outcome of the discussions.

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Chapter 8 Empirical findings and analysis

8.1 Theoretical model revisited

The Micro-Macro Linkage Approach was proposed in Chapter 2 as the theoretical model to be applied to this research. The Model developed by Zhao in 1996 suggests that foreign policy as an output results from the mutual influence between factors at both micro and macro levels, with the terms micro and macro being completely relativistic. By macro level, Zhao (1996) refers to international elements relating to the international system and structure as well as domestic determinants including the aspects of society and internal institutions. For micro level, he means the decision-makers who can either be individuals or small groups.

He explained that the Micro-Macro Linkage Model emphasizes the three-way interactions of those factors identified at each level. While constraints at international level and determinants at domestic level are involved in a dynamic relationship at the macro level, they also converge on, and receive feedback from, individual decision-makers (Zhao, 1996). As the interactions are situational and case contingent, the variables concerned to one situation or case can be different from another in terms of time, space, and particular issues. In applying his model to China's foreign policy making, he introduced an analytical framework highlighting how the changes at macro structural level, which has three dimensions, would influence the changes at micro process level, thus resulting in the policy change (Table 8.1).

Table 8.1 Micro-Macro Linkage Model of Chinese Foreign Policy.

Macro structures	Macrostructural change	Micro process in Beijing
Symbolic macrostructure	From revolution to modernization	Orientational change in the interpretation of the internal and external environments, learning and adaptation, and the changing priorities of foreign policy
Institutional	From vertical	Increased scope and degree of

macrostructure	authoritarianism to horizontal authoritarianism	participation in foreign-policy making; Changes of rules, norms, and mechanisms in the policy- making process
Power/regime macrostructure	From rigidity towards flexibility	Dynamics of individual leaders' power and authority; Regime legitimacy; Decision-maker's preference and choices; Foreign policy strategies and tactics.

Source: Zhao (1996)

He further elaborated that the first dimension of the Micro-Macro Linkage Model concentrates on how fundamental changes in the symbolic macrostructure have affected Beijing's interpretation of the international and domestic environment, which are then translated into the priorities of its policy agenda. The second dimension deals with the impact on China's foreign policy changes in the institutional macrostructure, which refers to the established systems through which policy-makers must operate. The third dimension, the power/regime macrostructure, sheds light on the importance to the policy-making process of the realm of power, its processors and their means of controlling and wielding it. This dimension is mainly concerned about how different sources of power are allocated within China's foreign policy community and how they are mobilized by different groups in a struggle for the control over policy-making (Zhao, 1996). The Model is synthesized with an intention of laying out an analytical framework as a starting point to study foreign policy issues so as to allow researchers to interpret the causal relationships among various factors at the micro and macro levels, which act on the decision makers who make the policy choice.

The model is identified as the theoretical framework that can be employed in the analysis of China's international air transport policymaking. As discussed in the preceding chapters, international air transport is, though by nature a commercial activity in the realm of international trade, attached with a political significance, with a nation's policymaking carrying more political considerations. Despite its political features having started to fade away since the US launched Open Skies in 1992, considerations for the policymaking are still centred on the principles of sovereignty, equality and fairness. Negotiations of airlines operational agreements are still conducted at the governmental level with national interest having remained the first priority to be considered.

This chapter, therefore, applies this model to analyse China's international air transport policymaking with the aim of identifying the relevant factors at international, domestic and institutional levels and examining how these factors interact with each other to have an impact on the decision-makers. An analytical framework is developed by the author (Table 8.2), which will help to identify the factors at international, domestic and institutional levels that have influenced the policymaking process. The focus is to examine how these factors have interacted with each other, affected the domestic policy, operational environment, have shaped and changed the mindset of the policymakers who determine the policy outcome. It will also examine how the factors have evolved over the years and discuss whether there are any factors that have played a bigger role in influencing the policy makers' final decisions.

Table 8.2 The Micro-Macro Linkage Model analysing China's international air transport policymaking.

Macro structures	Macrostructural change	Micro process in China
Symbolic macrostructure	From control to encourage competition;	Changes from refusing to use the term of "liberalization" to welcoming, embracing and accepting the trend and formulating proactive measures

		to open up the market.
Institutional macrostructure	More institutional norms and mechanisms are conducive to the promotion of competition in the international market; Institutional reform not affected power.	Diversified interests are perceived at the national level, with interest groups being active in lobbying the policy-making process with respect to specific bilateral markets; Coordination with/advice-seeking from peer ministries and bureaus
Power/regime macrostructure	Reform-oriented decision-makers are able to embrace the trend and take actions.	More flexible in formulating policies and strategies but assertive in addressing issues to win time for weak and disadvantaged domestic air transport industry.

Source: Composed by the author

8.2 Recalling the bilateral negotiations between China and the US, the Netherlands and the UK

Chapters 6 and 7 provide a detailed description of the bilateral negotiations between China and the US, and the Netherlands and the UK respectively. In line with the chronology of each negotiation between China and the three respective countries, the chapters also described the pre-consultation environment by analysing the economic conditions, bilateral trade between each two country-pair markets, political relationship as well as the performance of airlines. It investigated the expectations of the policy makers, discussed their considerations in evaluating the policy choices, and examined the reactions of stakeholders and the implementation of negotiations results. Briefly, of the three country-pair markets studied, the UK is the first country that established air links with China in 1979, followed by the US in 1980 and the Netherlands in 1996. In the 1980s, discussions with the 3 countries stalled for various reasons. The momentum

gained since the 1990s which saw the establishment of air links between China and the Netherlands, as well as numerous rounds of bilateral negotiations between China and each of the three countries respectively, which started to progressively eliminate the economic restrictions on airline operations. Fundamental changes did not take place until the last 10 years in the 21st century, during which period of time, at least two rounds of discussions were conducted between China and each of the three countries, resulting in substantial relaxation of the constraints imposed on the operations in air transport markets, with remarkable achievements being widely recognized. Table 8.3 summarizes the chronology of the bilateral negotiations in the year when “MOU” or “Protocol” was agreed and signed so that an overview of the flow of events can be developed.

Table 8.3 Chronology of the bilateral negotiations between China and the US, the Netherlands and the UK.

Year	China-the US	China-the Netherlands	China-the UK
1979	X	X	ASA
1980	ASA	X	X
1982	Yes	X	X
1985	X	X	Yes
1990/1991	X	X	Yes
1992	Yes	X	X
1994	X	X	Yes
1995	Yes	X	X
1996	X	ASA	X
1997	X	X	Yes
1998	X	Yes	Yes
1999	Yes	X	X
2003	X	Yes	X
2004	Yes	X	Yes
2006	X	Yes	X
2007	Yes	X	X
2010	X	Yes	X

2011	X	X	Yes
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Source: www.caac.gov.cn

(Remarks: “Yes” means that negotiations were held in that particular year with agreement being reached. “X” indicates no consultation or agreements are reached in that year.)

8.3 Analysis on factors at the international, regional and bilateral levels

Gourevitch (1978) argued that international political economy has a substantial impact on domestic structures and the preferences of domestic groups, which implies a variety of effects on specific decisions, policy outcomes, and regime type and coalitions. The change in international circumstances and the trade conditions in the world market tend to increase the pressure on an individual country, including those highly insulated developing and Communist countries, industries and firms, which have to adjust their policies for a more favourable environment to facilitate their competition and operation on a global scale (Frieden and Martin, 1996). Although an authoritarian state by nature, China is not an isolated entity but rather embedded within the international system (Feng, 2006), despite it having not adopted its Open-Door Policy until 1978. Along with its integration into the international political and economic system, the country’s foreign trade, an area which the government attempts to synthesize into the world market, has been subject to more influences from different sources (Feng, 2006). These influences are not only from international regimes at a global level but also from regional institutions, its peripheral neighbours and its negotiating counterparts at bilateral level. The following provides a detailed examination and analysis of how international sources have affected China’s international air transport policymaking

8.3.1 The global regime and its impact on China’s international air transport policymaking

China only became a member of the United Nations (UN) in 1971 with a primary impetus being to gain international recognition and status to break out of its global isolation that had existed since the establishment of its government in 1949 (Kent 1999). Though being inexperienced in the early days, China recognized the significance

of engaging itself in international institutions. Politically, such participation would enable the country to leverage its position in international community for its own benefits while play a key role in constraining the behavior of other international actors so as to prevent any decisions adverse to its national interests and infringements on its internal governing capacity (Lampton, 2001). Economically, the international institutions serve as the best platform to avail China of optimal opportunities to gain access to international resources for aid, investment, technology and information, to promote its export-oriented economic growth, to enhance its international status from both political and economic perspectives and to achieve its strategic goal of becoming a modernized and strong country in the world system.

To accumulate experience in the international political arena, China initially chose to join a couple of international institutions which are more technically oriented rather than politically focused, thus becoming a Contracting State of ICAO in November 1971 (www.caac.gov.cn). As it gained more experience, the country joined more international institutions from the 1980s including the World Bank and the IMF. By the beginning of the twenty-first century, China had entered the fully international phase of its interaction with the world, becoming a member of more than 100 international organizations. Its flexibility, confidence and maturity in a globalised environment has enabled the country to draw support from these organizations to promote and protect its national interest, to develop its economy, to further its international influence, and to boost its role as a key international player (Kent, 2007).

8.3.1.1 China's accession to the WTO

The WTO developed out of the GATT which dated back to 1947 (www.wto.org), whose overriding purpose is to help trade flow as freely as possible to promote economic development and the well-being of society. As one of the intergovernmental organizations under the UN system currently with 153 Member States, the WTO stipulates rules and regulations through multilateral negotiations among member governments. It is the set of these rules signed by the bulk of the world's trading nations that are at the heart of the WTO system, which is binding for every member state to keep its trade policies non-discriminative, transparent and within the agreed limits

(www.wto.org). Accordingly, the member government has the legal responsibility to honour the agreements signed under the WTO regime and abide by its rules.

China's efforts at joining the WTO started in the mid 1980s but it was not until November 2001 that the marathon negotiations were completed with the country being officially accepted by the organisation. China's entry was considered significantly important for both the WTO and China. On the one hand, by taking China, which is a large, dynamic and increasingly important trading nation, into the organization, the WTO would expand and strengthen the coverage of the multilateral rule-based trade system and add another major player to its negotiating process. On the other hand, the WTO entry would also enable China to continue its process of liberalization, thus further boosting its international trade and investment and enhancing its global integration (Australian Department of Foreign Affairs and Trade, 2002).

Becoming a WTO member state requires China's demonstration of its commitment to honouring all of the WTO rules and implementing the "catch-up" trade liberalization to bring its protective trade regime in line with comparable WTO Member States (Thomson, 2003). The biggest challenge for the nation is to transform itself to a more transparent rule-based system with respect to its trade and trade-related regime. To this end, China needs to take action to bring its existing laws and regulations into conformity with the WTO rules.

To this effect, China has made three tiers of commitment. The first tier is the commitment to the spirit of the WTO, such as free trade, most favoured nations, national treatment and transparency, which is expounded in the various documents of the WTO. The second tier is the commitment to the set of rules governing the practice and trade for industries such as agriculture, information technology, banking and financial services, telecommunication, and transport and logistics. The third tier is the commitment made in the bilateral agreements which China has signed with its major trading partners, especially with the US that holds the key to China's membership status (Ching and Ching, 2003).

Consequently, China has developed a Schedule of Specific Commitments (the Services Schedule) that it would achieve within a certain period of time, which has identified

several service sectors to which China would apply its WTO market-access and national-treatment obligations, as well as the exceptions from these obligations which it intends to maintain (Yeaman, 2003). The commitments include removing market entry barriers and eliminating laws and regulations that are incompatible with the WTO terms while issuing new legislation and regulations designed to comply with the WTO requirements (Kapp, 2002). In terms of transport and logistics, the “Several Opinions on Accelerating the Development of Modern Logistics in China” (the Logistics Opinion), issued by CAAC together with several other ministries, became effective in July 2002, which permitted foreign investors to establish logistics enterprises and to provide services for international distribution and third-party logistics (Yeaman, 2003).

In terms of civil aviation, the WTO only covers aircraft maintenance and CRS. International air transport is treated as a trade in services under the WTO and efforts at reaching a unified regime governing its economic activities, which ICAO failed to achieve since 1944, started in the 1980s at the Uruguay Round of Negotiations. However, due to the existing bilateral arrangements between Member States which are ICAO but not necessarily WTO Member States, such a multilateral negotiation has not brought about any consensus to date. The WTO set up a working group to assess the impact of liberalization of international air transport in the Doha Round of Negotiations which was launched in 2001, with the main objective being to apply the fundamental WTO principles of non-discrimination, free trade and liberalization to international air transport.

In this respect, China has been committed to the following:

- In aircraft maintenance, China would allow Chinese aircraft to be repaired outside China; allow the establishment of joint-ventured maintenance facilities with the Chinese side taking the controlling stake and being eligible to provide services in the international market;
- In CRS, China would allow foreign CRS to connect with Chinese CRS and provide services to Chinese carriers and their agents; however, China would not allow foreign companies to invest and operate independent CRS services;
- In pricing, China should not discriminate any foreign persons, corporate and

foreign-invested businesses in the provision of air transport services;

8.3.1.2 ICAO and its call to liberalise international air transport

As a specialized agency of the UN with 190 Member States, ICAO is the international institution that stipulates rules and regulations governing international air transport, though more technically from a safety and security perspective rather than economically, as a consequence of failure to reach an agreement in Chicago in 1944. The “aims and objectives of ICAO are to develop the principles and techniques of international air navigation and to foster the planning and development of international air transport so as to insure the safe and orderly growth of international civil aviation throughout the world; to meet the needs of the people of the world for safe, regular, efficient and economical air transport; and to promote safety of flight in international air navigation”, as declared in Article 44 of Chicago Convention (www.icao.int). Although ICAO is empowered with law-making authority, its policies and guidance material in the economic field (such as Assembly Resolutions, Declarations and Recommendations of air transport conferences) are generally of a recommendatory nature. This is in contrast to the Standards and Recommended Practice (SARPs) adopted by ICAO in the technical field which are binding on all of its Contracting States (Wang, 2011). Hence, it is at the discretion of the Contracting States to determine whether to accept the policy guidance and to further decide whether and how to implement it (Wang, 2011). Having said that, it is noteworthy that as such policy or guidance is adopted at a global level, in most cases by consensus, it carries the weight of international acceptance, making it a kind of “moral obligation” for ICAO Contracting States to adopt, follow or apply in their regulatory practices (Wang, 2011).

Determined to promote free trade in airlines operations, despite its failure to get the rest of the participants at the Chicago Conference to accept its proposal of free trade, the US launched Open Skies initiatives in 1992 which removed many economic restrictions in international air transport operations. Such a practice is by nature contrast to the principles of the Chicago Convention which upholds sovereignty and equal and fair opportunity for each and every member state. The aim of which is “to insure that the rights of Contracting States are fully respected and that every State has a fair

opportunity to operate international airlines and to avoid discrimination between the Contracting States” (Chicago Convention, 1944). Observing domestic deregulation of the US market as well as its promotion of Open Skies initiatives in international operations, ICAO had only made a Declaration of Global Principles for the Liberalisation of International Air Transport in 1994 at the 4th World Air Transport Conference, two years after the US signed its first ever Open Skies deal with the Netherlands. Rather than urging its Member States to take action in this aspect, ICAO, having “noted the changes in the regulatory and operating environment of international air transport brought about by economic development, globalization, liberalization and privatization”, emphasized the “critical importance of safety and security in international air transport and reaffirmed that the basic principles of sovereignty, fair and equal opportunity, and cooperation set out in the Chicago Convention should continue to provide the basis for future development of international civil aviation” (Abeyratne, 2003). It “called on the Member States to ensure a high level of safety and security and to respect national sovereignty” (Abeyratne, 2003). Such a cautious and conservative approach towards the liberalization of international air transport apparently did not motivate nor encourage its Member States to pursue a liberalized policy, but left the US the sole hegemon in the world to promote its beliefs in liberalizing the industry.

The next move from ICAO did not come until almost 8 years after the 1994 Declaration. In March 2003, the 5th worldwide ICAO Air Transport Conference was convened in Montreal with 794 participants. It was at this Conference that ICAO, for the first time, declared its “full appreciation of globalization and liberalization, calling its Member States, to the extent feasible, to liberalise international air transport market access for carriers and their access to international capital markets and their freedom to conduct commercial activities” (ICAO Declaration, 2003). The general position of ICAO towards liberalization is that it is up to each State to “determine its own path and pace of change in international air transport regulation, on the basis of equality and opportunity, using bilateral, sub-regional, regional and/or multilateral approaches according to circumstances”, with the objective of liberalisation being “to create an environment in which international air transport may develop and flourish in a stable, efficient and economical manner without compromising safety and security and while respecting social and labour standards” (ICAO Declaration, 2003).

ICAO's declaration in 2003 remained as a statement which did not carry any mandatory requirement for the Member States to be obliged to take action. Thus, it could only be regarded as a push to raise the awareness of the Member States of the irreversible trend of the industry. As a Contracting State with a seat in the Council, China honours its obligation under the Chicago Convention, upholds the principles of sovereignty, fair and equal opportunity, non-discrimination, interdependence and cooperation and gives due regard to ICAO's policies and guidance in its decision making with respect to international air transport (Wang, 2011). China follows the trend of liberalisation but decides on its own policy and own pace of change. ICAO's view and information on the changes that are taking place with respect to liberalization as well as its policies and guidance on how to adapt to the changes in terms of policy options and various approaches certainly have helped China in getting to know what is happening outside its territory and in its policymaking (Wang, 2011). The Declaration prompted China's immediate response, with a policy statement being announced at the same Conference, which declared that China would take an "active, progressive, orderly and safeguarded manner" in liberalizing its air transport market (www.caac.gov.cn).

8.3.1.3 The impact of China's WTO membership and ICAO's advocacy for liberalisation on China's international air transport policymaking

International organisations are understood to be the institutional representations of internationalisation and interdependence (Kent, 2007). They represent an organising process of conflict management at the supranational level as well as a collective organising response to a multiplicity of control problems in a world of contradictory trends (Kim, 1994). The benefits of being involved in international community not only include the help received to stabilise identities, codify interests, enshrine moral principles and resolve cooperation problems, but also its commitment to complying with the norms, principles, rules and their associated treaties (Kent, 2007). Thus, pressure to comply with the rules has already been built into the existing system that Member States are obliged to accept (Kent, 2007), with Chayes and Chayes (1995) pointing out that international organisations constitute some of the primary sources of pressure for obtaining Member States' compliance with regime norms. They and their treaty regimes not only encourage transparency, cutting transaction costs, building

capacity and enhancing settlement, but also, through a process of “jawboning” persuade parties to explore, redefine and sometimes discover their own as well as mutual interests between Member States .

China’s accession to the WTO is regarded as one of the single most significant benchmarks in its process of opening and restructuring the country’s economy, a process that has been delivering continuous, rapid and fundamental changes since 1978 (Yeaman, 2003). Behaving as a cooperative and compliant actor in the international regime (Kent, 2007), China is fully aware of its legal obligation to honour and comply with the WTO rules. Being involved in international organisations and sitting in the Council have profoundly changed not only China’s view of the world, but also its view of itself (Kent, 2007). China has accepted the obligations by acting responsibly to ratify the rules and associated treaties, which have been accordingly entrenched in its domestic law (Kent, 2007). “Once inside the WTO, China will strictly comply with the universally acknowledged market rules, implement open, transparent and equality-based policies of trade and investment, and endeavour to promote a multi-directional and multi-level opening-up in a wide range of areas”, as China’s President Jiang Zemin pledged (Kent, 2007). The ideology also started to change in the early 21st century when China became more integrated into the international community, which has brought about policy change. China reduced the central control over its commercial policy, necessitated a significant reduction in tariffs, removed non-tariff barriers and quotas, provided further protection of intellectual property rights, and eliminated many barriers to trade in goods and services (Kent, 2007), though relaxation of barriers in doing business has been introduced in a phased-in manner so as to ensure that the pace of change is gradual, manageable, without a big-bang effect.

Although the WTO rules do not apply to international air transport, some rules such as removing trade barriers apply to its air transport industry. Its membership has compelled China to take immediate and effective actions to overhaul its regulatory regimes, ease market entry barriers and eliminate restrictions on operations for a fair and equal playing field for both domestic and international businesses. Specifically, CAAC has made the following policy changes regarding air transport.

In August 2002, CAAC issued new regulations with respect to foreign investment in China's air transport industry, allowing international investment in any existing public transport services, though the majority control of one shareholder was limited to a maximum of 25 percent. Statistics from CAAC showed that 8 foreign invested projects were approved in 2002 with a contracted value of \$80 million. The figure increased to \$110 million in 2003 with 6 projects being approved (www.caac.gov.cn). In early 2003, CAAC made a comprehensive and thorough examination of its 224 regulations, orders and procedures that had been issued between 1980 and 2002, resulting in 129 of the documents being revoked or abolished. A further revision of its existing regulatory documents in 2005 terminated another 40 regulations, which, to a great extent, eliminated the restrictions on economic operations of the industry. Airport and ATC charges with respect to international operations were adjusted without any discrimination to foreign carriers, which became effective as of 1st November 2005.

In the same year, a "Leading group to promote international air transport development" was set up in CAAC, being charged with the responsibility of formulating the country's air transport development policy and enforcing its coordinated implementation. A package of guidelines was thus issued, which included:

- The gradual liberalization of the domestic market in a phased-in manner;
- The opening of the international cargo market immediately;
- The support and promotion of international air transport in central, western and northeastern regions;
- The strengthening of gateway and hub airports;
- The formulation of an open, fair, and transparent mechanism to assess and approve international route licences;
- The reform of the approval procedures for additional international scheduled and charter operations;
- The encouragement and support for airlines to open international routes with less market demand but required for national diplomatic needs;
- The establishment and streamlining of the management of airport slots, CRS, and airport ground handling services; and
- The promotion of simplified passenger procedures and e-tickets (CAAC, 2005).

To further demonstrate its commitment to liberalising the market, CAAC agreed a package of arrangements with Hong Kong SAR under the scheme of the Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA), which allowed service providers of Hong Kong and Macau to offer airport contract management services with no longer than 20 years of contract. It also allowed the establishment of joint ventures or collaboration of ticketing agencies in the mainland (CAAC Annual Policy Statements of 2005, 2006 and 2008).

In response to ICAO's call to liberalise the air transport market, CAAC reiterated its stance in its 2004 Annual Policy Statement, affirming that China would adjust its international air transport policy under ICAO's guidance (Wu, 2007). It would seek to establish air transport relationships with countries all over the world, with the intention of or the interest of Chinese carriers in operating a specific international route not being the sole and exclusive consideration for the Chinese government in negotiating any bilateral ASAs (Wu, 2007). Specifically, the policy statement included the following key objectives:

- To positively embrace the trend of air transport liberalization;
- To support China's overall diplomatic policies;
- To support China's Open-Up strategy and the objectives of social and economic development;
- To give due regard to satisfy the demand for international air transport required by the country's foreign trade and travel industry;
- To strengthen the air links between Western, Northeast and Central China and the outside world;
- To balance the national interests, public interests and industry interests;
- To develop the hub strategies;
- To enhance the overall competitiveness of the industry; and
- To seek cooperation to achieve a win-win situation, but not at the expense of China's national security, for the expansion and growth of the whole industry.

To implement the policy, CAAC has developed detailed strategies that have been observed in each and every bilateral negotiation. In 2003, China agreed more relaxed

arrangements with 12 countries at a bilateral level including the Netherlands, Australia, France and Japan, which removed restrictions on designation (2003 CAAC Annual Policy Statement, 2004). In 2004, the country conducted 15 bilateral ASA consultations including the US, the UK, Germany and Russia which significantly liberalized the market entry arrangements, though to a different extent. In particular, the 2004 Protocol with the US was regarded as a milestone in China's history in liberalizing its international air transport market, which involved a comprehensive overhaul of the original restrictive bilateral ASA signed in 1980.

By May 2007, CAAC had achieved the following:

- Of the 108 bilateral ASAs signed between China and its counterparts, 74 allowed multiple designations, representing 68 percent of the total;
- Relaxed the control on route schedules with 10 countries, allowing for unlimited operation to intermediate, destination and beyond points;
- Removed capacity restrictions on 3rd and 4th traffic rights for both passenger and cargo operations with 7 countries;
- Removed capacity restrictions on 3rd and 4th traffic rights for cargo operations with 6 countries.

In addition to the above, China has allowed third party codeshare arrangements with 34 countries, wet-lease arrangements with 22 countries, 5th freedom traffic rights for cargo operations with 7 countries and 7th freedom traffic rights for African airlines when operating cargo charters. China also agreed to relax pricing regime to adopt the “origin principle” or the “double disapproval principle”.

8.3.1.4 Summary

While sovereignty remains one of the key principles in the Chicago Convention governing international air transport, it has always been a paramount concern for China too in negotiating its international air transport agreements. Taking air transport as an integral part of its national defence system, China has taken a cautious and conservative view towards liberalization of the industry. However, its membership of international organizations such as the WTO has changed the mindset of policymakers who reversed

their view towards liberalization which has been widely accepted in the international community. ICAO's Declaration in 2003 has encouraged the nation to take a proactive approach towards the issue. For the first time, CAAC issued an aviation White Paper in 2004, which reviewed China's policy change in 2003 and proposed a policy portfolio, with special attention being given to developing China's international air transport. CAAC, hence, developed specific plans, objectives, strategies and tactics for each round of bilateral negotiation with the aim of optimizing the outcome of the consultations. In so doing, CAAC aims at speeding up the liberalization process of its international air transport market while at the same time providing opportunities for its industry operators to gain international experience. Faced with the inevitable trend towards liberalisation of air transport, the Government has now been convinced that the best strategy is to take the challenge proactively rather than wait for defeat. "We should open our market selectively and gradually in order to promote market prosperity and improve the service level and competitiveness of our businesses through the introduction of competition in an open environment" is now CAAC's view.

The bilateral arrangements between China and the US, the Netherlands and UK that had been concluded before 2003 had various kinds of restrictions, though to a different extent, on market entry, capacity, pricing and other doing business issues. After 2003, the arrangements agreed at each round of discussions contained significant relaxation of restrictions on designations, capacity, investment and other doing business issues. Though what has been agreed with each country at each round of discussions is different, generally, market entry has been relaxed, constraints in route schedules have been eliminated and capacity has been increased. The principle that the Chinese government upholds is to open the market cautiously, selectively and gradually so as to create a relaxed market environment. Industry interest is no longer the exclusive concern of CAAC when formulating the objectives of bilateral negotiations with its counterparts, but rather, national interest and spill-over effects to other industries such as tourism and international trade have taken more weight in its considerations. Individual carriers are encouraged to participate in the competition for its survival.

8.3.2 China's link with regional institutions

8.3.2.1 ASEAN and its Open Skies Initiative

The Association of Southeast Asian Nations (ASEAN) was established on 8th August 1967 in Bangkok by Indonesia, Malaysia, the Philippines, Singapore and Thailand with the signing of the ASEAN Declaration (www.aseansec.org). Later joined by Brunei, Vietnam, Lao PDR, Myanmar and Cambodia, ASEAN is now made up of ten Member States in the region. As one of the world's most durable regional groupings (UNESCAP²⁵, 2010), ASEAN is more concerned about security issues with promoting regional peace and stability through abiding respect for justice and rule of law in the relationship among countries of the region being its primary aim, though it also recognizes economic concerns as it strives to collaborate more effectively for the greater utilization of agriculture and industry, the expansion of the trade, including the study of the problems of international commodity trade, the improvement of the transportation and communications facilities and the raising of the living standards of their people (www.aseansec.org).

In contrast to the EU, which is formed on the basis of the Treaty of Rome with its laws, regulations, rules and policy directives being binding to its Member States, ASEAN was formed on the basis of an understanding contained in the Declaration. After more than four decades of consolidating the ties among its members, ASEAN is now in the process of renewing itself as the "ASEAN Community" with a new Charter being passed and becoming effective in December 2008 (UNESCAP, 2010). The Charter serves as a legally binding agreement among the 10 ASEAN Member States and provides a legal status and institutional framework for the organization to be enabled to cope with the dynamic development.

Air transport has been recognized as an important sector for cooperation between ASEAN Member States, given the role it plays in facilitating regional trade activities. Back in 1994, the ASEAN Plan of Action in Transport and Communications in 1994—1996 was formulated focusing on the development of a multimodal transport system to improve interconnectivity within the region and harmonise regulations (Yean, 2010).

²⁵ UNESCAP refers to United Nations Economic and Social Commission for Asia and the Pacific.

Effective management of air space was emphasized although no initiatives were taken to liberalise the markets. In 1997's ASEAN Plan of Action in Transport and Communications, the development of a competitive air services policy was identified as a key area for the Member States to collaborate, which led to the conclusion of the ASEAN Memorandum of Understanding (MOU) on Air Freight Services in 2002, although the contracting states were still limited to a maximum of 100 tones of carriage in freight operations per week. The momentum continued in 2008 when The ASEAN Multilateral Agreement on Air Services and the Multilateral Agreement on the Full Liberalisation of Air Freight Services was signed, which became effective in 2009 (Yean 2010). It is expected that an ASEAN Single Aviation market is to be achieved in 2015.

8.3.2.2 China's collaboration in air transport industry with ASEAN Member States

China was first officially linked to ASEAN in 1991, when the then Chinese Foreign Minister Qian Qichen attended the opening session of the 24th ASEAN Ministerial Meeting (AMM) in Kuala Lumpur and expressed a strong interest in forging cooperation with ASEAN for mutual benefits. The relationship was formalized in July 1996, when China was accorded a full Dialogue Partner status at the 29th AMM in Jakarta.

Over the years, China has been proactively involved in ASEAN activities and pushed openly for the establishment of a China-ASEAN Free Trade Area (CAFTA). In order to ensure the successful launch of CAFTA, the then Chinese Premier Zhu Rongji proposed to start an annual Transport Minister Meeting (TMM) in November 2001 so as to enable the participants to discuss and coordinate policies and issues relating to transport collaboration and development, which is the key to facilitate the effective establishment of CAFTA. At the ASEAN Plus Three Summit²⁶ held in November 2001, China offered to open its market in some key sectors to ASEAN countries five years before they reciprocated. China also offered to grant special preferential tariff treatment for some

²⁶ ASEAN Plus Three Summit is an informal summit of the ten ASEAN states, China, Japan and the Republic of Korea (South Korea).

goods from those less developed states, such as Cambodia, Laos and Myanmar (Sheng, 2003). Though the initial response was cautious, ASEAN accepted China's proposal with the Framework Agreement on Comprehensive Economic Cooperation being announced in November 2002 in Cambodia at the ASEAN-China Summit, which stipulated that 2010 would be the inception year for China and the six original ASEAN states, namely Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand, while 2015 would be the year for the less developed ASEAN members of Cambodia, Laos, Myanmar and Vietnam (Sheng, 2003).

The year 2002 saw China's attendance at the first TMM, with the country's Deputy Administrator of CAAC delivering a speech on China-ASEAN air transport relations. In the second TMM in October 2003, China proposed a Memorandum of Understanding on Transport Cooperation covering all transport modes including air transport, which called for collaboration on infrastructure construction, project investment and financing, collaboration between airlines, exchange of information and the establishment of an Open Skies zone through bilateral phased-in and progressive arrangements (www.caac.gov.cn). In particular, it called for "the relaxation of restrictions with respect to the number of points in route schedule, no limitation on 3rd, 4th, and 5th freedom traffic rights, no limitation on frequency and capacity as well as type of aircraft, and multiple airline designation" (www.aseansec.org). The MOU was signed in November 2004, setting the roadmap for both parties for an effective implementation. This coincided with the initiative launched by Singapore, Brunei, Thailand and Malaysia which concluded a multilateral agreement for passenger services allowing unlimited direct flights between any destinations in the named countries (Yean, 2010).

China's championing of forging a free trade zone with ASEAN Member States has paid back to China, which has enjoyed a 15 percent increase of trade year on year since 1995. The trade volume reached \$54.77 billion in 2002 and jumped to \$105.9 billion in 2004. The share of China-ASEAN trade in China's total trade volume also increased from 7.0 percent in 1996 to 9.2 percent in 2004 (Ku, 2006). Except for Laos, all the rest of the ASEAN countries have agreed ADS arrangements with China, with Malaysia, Singapore, the Philippines, Thailand and Indonesia being on the list of the top 20 tourist resource countries to China. ASEAN currently is China's 5th largest trade partner, while

China ranks 6th from ASEAN's perspective. China hopes that in the future the ASEAN countries will be a prospective market for its aircraft-manufacturing projects such as the ARJ21 (Williams, 2009). By forging a closer political relationship and providing magnificent economic support and concessions with these countries, China has gained the comparative advantages of enjoying both geographical proximity to and political membership of the ASEAN aviation environment (Williams, 2009).

8.3.2.3 Impact on China's international air transport policymaking

China's involvement in regional political and economic collaboration only started in the late 1990s. Ever since then, China has prioritized bilateral free trade negotiations as one of its top agendas in its overall international strategic considerations. It has demonstrated a magnificent interest in joining regional organisations with an overwhelming enthusiasm in pursuing free trade with its trade partners at both regional and global levels (Hodley and Yang, 2008). Statistics showed that by the mid-2000s, China was talking with 27 countries and regions regarding the establishment of 9 free trade arrangements or Closer Economic Partnership Agreements, covering one fifth of its total trade (Hoadley and Yang, 2008). It has signed free trade agreements with 10 ASEAN Member States, Chile, Pakistan and New Zealand, and was negotiating with Australia, Iceland and countries in Africa and Central America. Proposals were also put forward to Japan, South Korea, India and nations in the Shanghai Cooperation Organisation (SCO)²⁷.

Such an ideological shift favouring free trade and liberalization did not come out of a vacuum. Over the years, China had experienced slow progress with limited influence in multilateral talks on economic issues at a global level during the WTO negotiations

²⁷ Shanghai Cooperation Organisation was an intergovernmental organisation founded in Shanghai, China in June 2001 with Member States including China, Kazakhstan, Kyrgyzstan, Tajikistan, Uzbekistan and the Russian Federation. The primary goal is to manage the potential Sino-Russian tensions or competition with overt activities being directed first at transnational threats as well as cooperation in areas such as economy and trade, science and technology, culture, education, energy, transportation, and environmental protection (Bailes et al, 2007, and www.fmprc.gov.cn)

(Hoadley and Yang, 2008), resulting in it getting frustrated over the effectiveness of the multilateral regime in addressing economic issues. Being determined to resume its position so as to play a stronger and more effective role in influencing the multilateral talks at a regional level rather than at a global level, thus maintaining its political position in the region while at the same time opening new markets for its businesses to avoid exclusion from or discrimination in the established markets (Hoadley and Yang, 2008), China began to appreciate that economic regionalism would affect the country more than economic globalization, hence, it became increasingly interested in the potential for regional liberalization, an arena where it could influence the course and process (Hoadley and Yang, 2008). Another motivation for China's enthusiasm in forging a close relationship with its neighbour countries such as those in ASEAN was to get itself more integrated with peripheral states through active participation, thus downplaying the "China threat" that might be exaggerated and played politically (Sheng, 2003). Making economic concessions through CAFTA would help to pre-empt an undesirable scenario, which would maintain a peaceful international environment favourable for the country's continuous economic growth.

Historically, China has had close air links with ASEAN Member States, with Thailand, Laos and Malaysia being one of the first to establish bilateral air transport relations. Before 1990s, airlines in both China and the Southeast Asian countries had not developed a sound hub-and-spoke system, with point-to-point bilateral markets being the focus of their operations. Governments regarded each country-pair market as an independent operation, hence restricting relaxed arrangements including 5th freedom traffic rights. Carriers of the US, UK and the Netherlands were more interested in their expansion across the Atlantic, leaving the Asian market as a second or third priority. In addition, the financial crisis in the region in the late 1990s had affected the air transport market, resulting in low traffic demand with airlines suffering big losses.

Surviving the crisis, the air transport industry in Asia has maintained a remarkable growth rate, with the potential of overtaking Europe and North America to be the most profitable market of the world. Regional economic integration requires close collaboration with each other, with air transport being a high demand to facilitate the harmonized process. Since 2002, China has held numerous discussions with ASEAN

Member States including Indonesia, Cambodia, Laos, Singapore, Malaysia, Thailand and the Philippines, resulting in significant expansion of air services arrangements in terms of the number of designated carriers, capacity, destinations, codeshare arrangements and 5th freedom traffic rights. In 2004, China and Thailand agreed an Open Skies accord which allowed unlimited operation of services between the two countries. In the same year, a total of 23 airlines, including LLCs such as Tiger Airways, Air Asia X and Jetstar Asia, were operating on 104 routes with 481 weekly frequencies between China and ASEAN countries, covering most of the major cities in the region (www.caac.gov.cn).

Although the air transport relationship between China and the ASEAN members does not have a direct impact on China's consideration with respect to its policies towards the China-US, UK and Netherlands markets respectively, China's changed mindset on liberalization with a proactive approach towards the China-ASEAN free trade zone and its relaxed arrangements with ASEAN Member States has served several objectives for the country:

- The participation in Open Skies Arrangements has enabled China to accelerate the marketisation of its economy and industry at large. CAAC is able to gain experience in bargaining with its trade partners for optimized benefits for its industry and society as a whole;
- The phased-in arrangements for establishing an Open Skies Zone has allowed its airlines to develop new strategies to adapt to the new environment and to build up its strengths for further expansion;
- The promotion of a regional free trade mechanism has exposed Chinese business to new competition as a result of the rationalization of market forces. Such competition has helped Chinese airlines to improve their efficiency and productivity, hence gaining experience in competing in the more dynamic world;
- The arrangements have enabled Chinese airlines to expand their networks into peripheral countries to strengthen their competitiveness in the region;

- The arrangements have enabled Chinese airlines to strengthen their regional hubs for further expansion. Airports such as Guangzhou, Shenzhen, Shanghai, Chengdu and Chongqing have had more international flights to serve the region, providing more point-to-point services as well as connecting services;
- The implementation of the liberalized arrangements and the performance of Chinese carriers would enable the government to assess whether the strategies and arrangements have brought about the benefits to the industry and society it wanted to, hence enabling it to adjust its strategies to suit its needs.

8.3.3 China's links with its peripheral countries

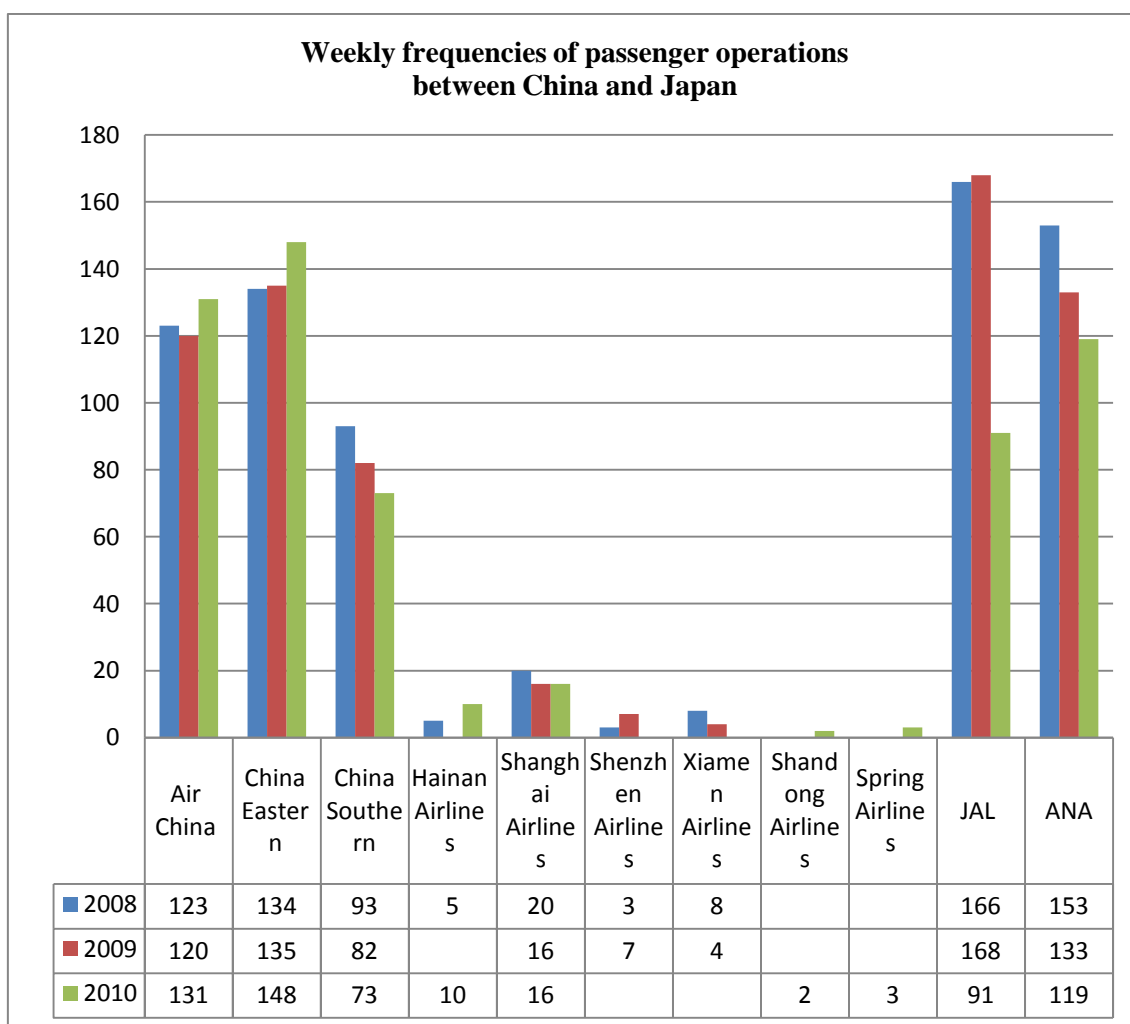
8.3.3.1 China and Japan

China and Japan normalized their diplomatic ties in 1972. Both being powerful and affluent in Asia, the two are undergoing domestic transformations that have had major regional and global economic consequences. As of 2003, the two economies already constituted 47.9 percent of the value of merchandise trade in Asia and 12.5 percent globally (Pekkane and Tsai, 2005). Their interrelated economies are increasingly tied up due to their complementary nature despite the constant rows leading to growing rivalry triggered by various historical issues (www.news.bbc.co.uk). Bilateral trade rose from \$18.2 billion in 1990 to \$236.6 billion in 2007 or 17.7 percent of total Japanese external trade, with Sino-Japanese trade exceeding that of the American-Japanese, making China the largest trade partner of Japan ever since then (Xing, 2008).

Air transport services between the two countries started in 1974 with one carrier being designated by each side. In 1986, the Japanese government initiated a policy change in international air transport, advocating multiple designation and more destinations to be served. The liberalized attitude brought about 7 Chinese carriers operating 383 passenger and 44 cargo weekly flights from 18 Chinese cities to 18 Japanese destinations and 3 Japanese carriers operating 210 passenger and 46 cargo frequencies per week from 5 Japanese cities to 9 Chinese destinations in 2010 (Figure 8.1 and 8.2) (www.caac.gov.cn). In 2006, of the 51.53 million international passengers originating from Japan, 10.8 million travelled to China, accounting for almost one fifth of the country's total traffic (Figure 8.3). A China-Japan Air Transport Dialogue was

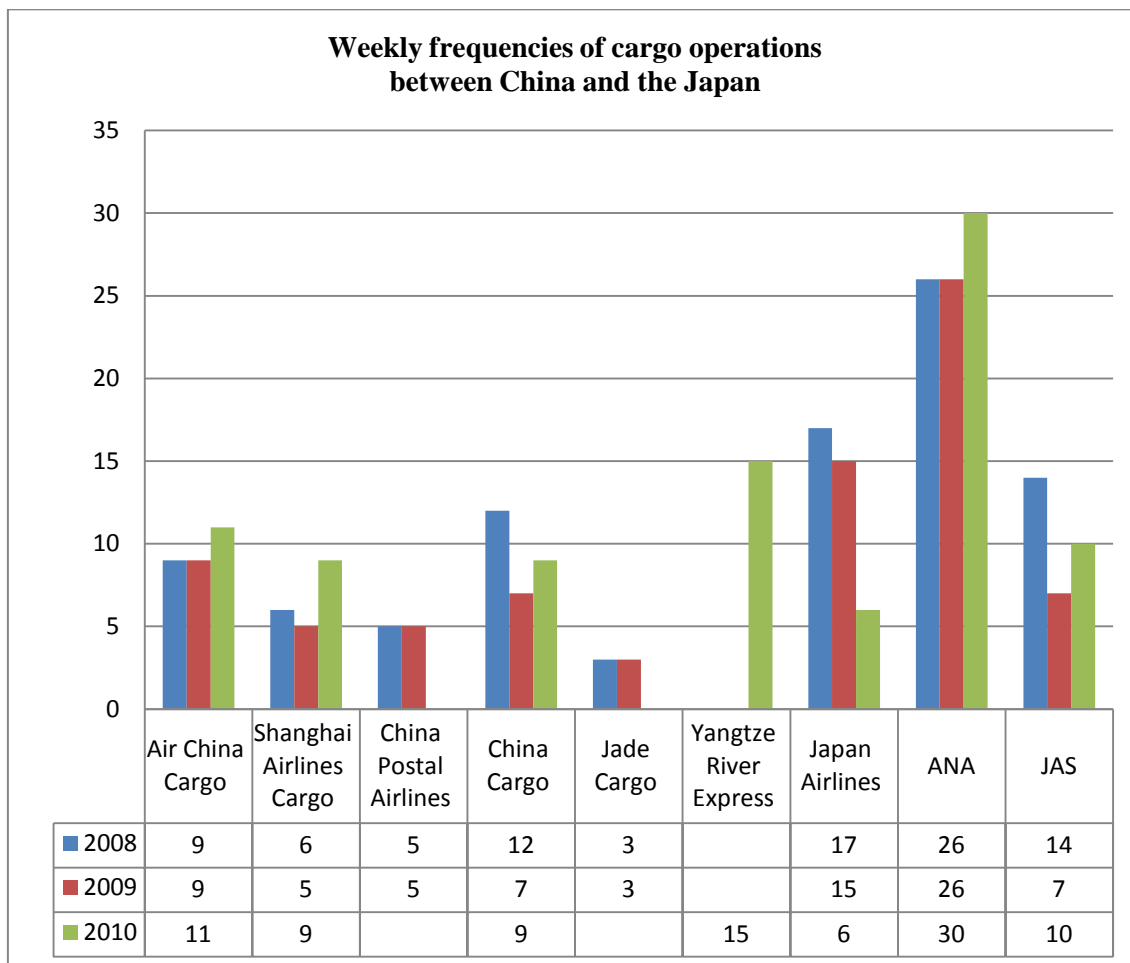
established in the same year too, which holds meetings at a ministerial level every year, with the primary objective being to encourage and promote collaboration in areas such as safety, investment, air traffic control and aviation security between the two countries. Liberalised air transport services arrangement is one of the key issues on the agenda at each Ministerial Dialogue, with progress being made in removing restrictions on bilateral operations, though slowly (www.caac.gov.cn).

Figure 8.1 Comparison of weekly frequencies of passenger operations between China and Japan from 2008 to 2010.



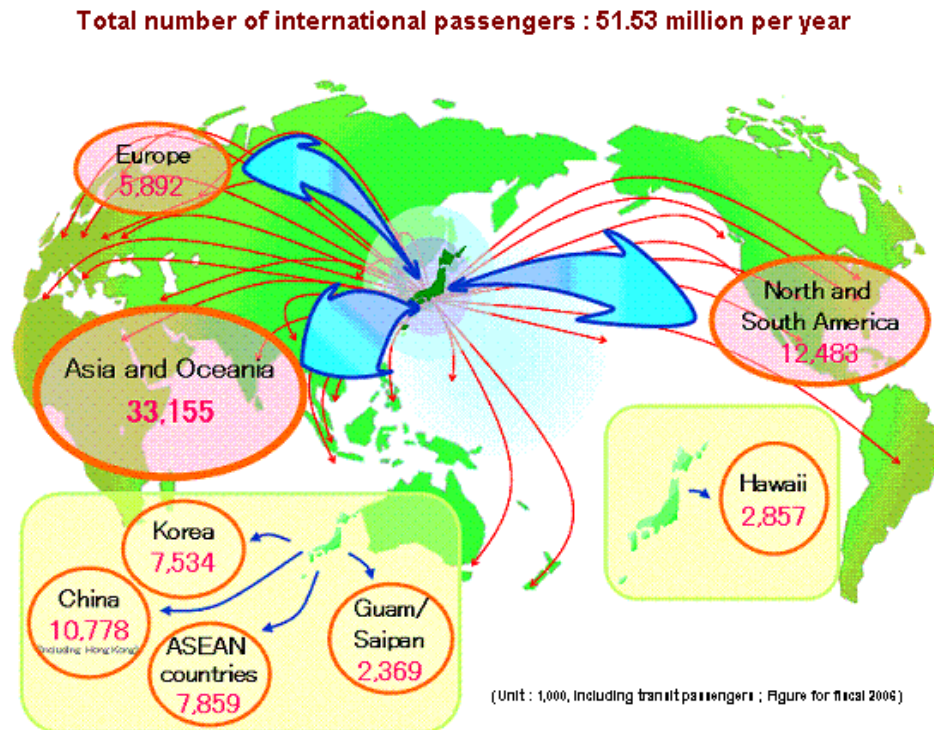
Source: www.caac.gov.cn

Figure 8.2 Comparison of weekly frequencies of cargo operations between China and Japan from 2008 to 2010.



Source: www.caac.gov.cn

Figure 8.3 Total number of international passengers travelling out of Japan and Japan-China passengers in 2006.



Source: www.mlit.go.jp

8.3.3.2 China and South Korea

Poised between China and Japan, fought over by the US and Russia, the Korea Peninsula has long played a central role in Asia's geopolitical affairs (Pan, 2006). Historical conflict on the Peninsula used to bring in China on the North Korean side and a US-led coalition on the South Korean side. The half-a-century long US-South Korea political and security alliance established after the Korean War blocked any contacts between China and South Korea, which only changed in the early 1990s.

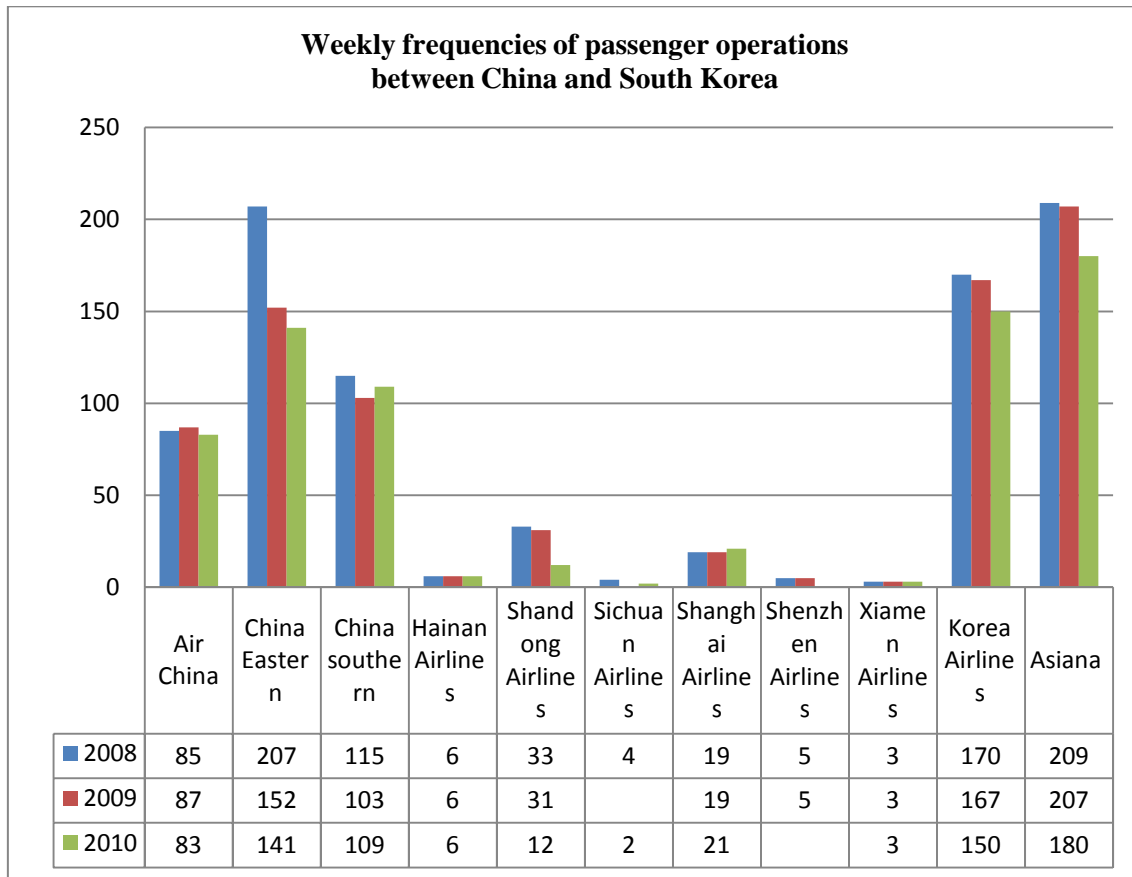
With economic growth since the 1980s, South Korea has shifted its focus towards increasing regional ties with its Asian neighbours including China, with whom diplomatic ties had not been established until 1992. South Korea hopes that by developing itself into a regional logistics and business hub, it would be able to play a bigger role in balancing the various parties in the region (Pan 2006). Being influenced

by Chinese culture and civilization, the Korean public also believe that in the long term, China is a more important country to them than the US, which can be used to counteract the American influence (Roy, 2004).

On the other hand, China too shifted its Korean policy in the early 1990s, favouring to cultivate a relationship with the South Korean government that would have much to offer the country economically (Roy, 2004). China was more motivated to attract investment and technology from South Korea whose economy had started to take pace in the 1980s and soon became one of the Four Tigers in Asia due to its dramatic economic growth. The two countries agreed politically to jointly oppose the Japanese Prime Minister's visit to the Yasukuni war shrine as well as work together to deal with North Korea's nuclear ambition. The improved political relationship stimulated bilateral trade, with China overtaking the US to become South Korea's largest trade partner in 2003 and South Korea being China's 5th largest foreign investor. In 2004 the bilateral trade reached \$90 billion, a 42 percent increase from the previous year.

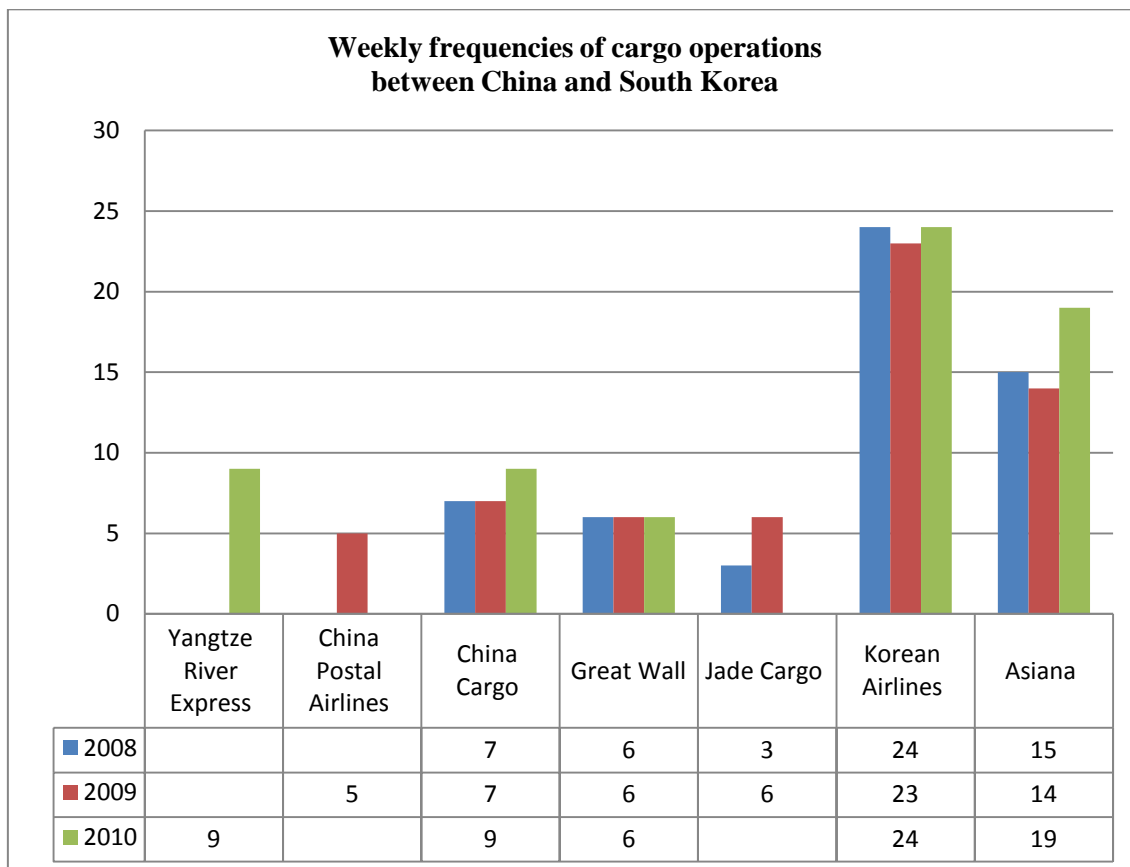
China-South Korea air transport services began in 1990, two years prior to the official establishment of diplomatic ties. They started as a charter service for the 1990 Asian Games, which was then converted to scheduled operation when the bilateral ASA was signed in October 1994 in Seoul. Initially, the two designated carriers e.g. Korean Air (KAL) and Asiana Airlines only operated to Beijing, Shanghai and Guanzhou. As Korean investment in China expanded from east coast in Shandong, Beijing, Tianjin, Liaoning and Heilongjiang to cities in central and western China, Korea's air transport services were extended to destinations such as Xi'an, Wuhan, Kunming, Changsha and Zhengzhou. Currently, 8 Chinese carriers operate from 26 cities to 7 Korean destinations with 377 weekly frequencies for passenger services and 3 Chinese all-cargo carriers operate from 5 Chinese cities to Seoul with 24 weekly frequencies. From the Korean side, the two Korean carriers originate from 5 cities to 25 Chinese destinations with 330 weekly frequencies for passenger services, and 2 Korean cities to 6 Chinese destinations with 43 weekly frequencies for all cargo services (Figure 8.4 and 8.5) (www.caac.gov.cn).

Figure 8.4 Comparison of weekly frequencies of passenger services between China and South Korea from 2008 to 2010.



Source: www.caac.gov.cn

Figure 8.5 Comparison of weekly frequencies of cargo operations between China and the South Korea from 2008 to 2010.



Source: www.caac.gov.cn

South Korea is fully aware that airports in Northeast Asian countries are competing fiercely for air transport demand, especially cargo, which are expected to take up to 42.2 percent of the world market in 2025 (www.english.mltm.go.kr). Airport expansions in Beijing, Shanghai, Guangzhou, Incheon, Nagoya and Tokyo Haneda are just demonstrations of such competition. In order to strengthen Korea's regional hub status, the government has set the goal of preparing a foundation that would allow safe and convenient air travel for people and at the same time develop its aviation industry into a leading one in the Asia-Pacific region (www.english.mltm.go.kr). To this end, the Korean government has accelerated the pace of liberalizing its air transport market, with 29 Open Skies agreements concluded by 2008 compared with 11 in 2002.

South Korea pushed hard for a regional liberalised air transport market and proposed to launch a China-South Korea Air Transport Cooperation Forum in August 2005, with the second Cooperation Forum held in December 2007. Creating a liberalized air transport zone for the region is one of the key items of the Cooperation, though progress being slow.

8.3.3.3 Open Skies between the US and China's peripheral states

In Asia, the US Open-Skies initiative began in summer 1996, with Macau SAR being the first to conclude such an agreement, followed by Singapore, Brunei, the Philippines, Taiwan (China), South Korea, Malaysia, Laos, Vietnam, India and Japan (www.dos.gov). One of the features worthy of note is that all the arrangements allowed 7th freedom traffic rights for cargo operation with limits remaining on 5th freedom traffic rights for passenger traffic. In May 2001, the US and 4 other pacific-rim nations (Singapore, Brunei, New Zealand and Chile) signed an accord known as the “Multilateral Agreement on the Liberalisation of International Air Transport”, with a new element being the full liberalisation of cargo operations between the 5 countries (Zhang and Zhang, 2002). Looking around at its neighbours, China has been surrounded by Open Skies agreements and is singled out as the only country in the region that has not concluded any Open Skies with any other countries of the world.

8.3.3.3.1 US-Japan Open Skies

Japan signed an ASA with the US in 1952, which enabled the US to designate 3 carriers, namely Pan Am (later replaced by United), Northwest (now part of Delta), and Flying Tiger (later acquired by FedEx) to operate to Tokyo, Osaka and Naha (after Okinawa was returned to Japan) and use these airports to operate to the rest of Asia including China with full 5th freedom traffic rights. In contrast, Japan was only able to designate one carrier, namely Japan Airlines (JAL), to operate to 7 points in the US, e.g. Anchorage, Honolulu, Los Angeles, New York and San Francisco, as well as Saipan and Guam, with 5th freedom traffic rights being allowed for only one beyond point (Yamauchi, 1997).

Soon afterwards, the Japanese government complained about the inequality of the traffic rights and the advantage enjoyed by US carriers, arguing that such an asymmetric

arrangement had hampered fair competition between the two countries, with the US side enjoying more flexibility in terms of designation, traffic right entitlement and capacity provisions, which put the Japanese side in a disadvantaged position. The following years saw several discussions between the two countries (in 1976, 1985 and 1989) but without much amendment to the 1952 accord (Endo, 2007). In the discussions held in 1997, the US pressed hard on the Japanese government for a liberalized deal that would scrap all restrictions allowing any airline to fly wherever it wanted between the two countries and beyond to other destinations in the fast-growing Asian market (Economist, June 1997). The rationale was that the US wanted to capture as much as it could of the lucrative Asian market, whose share of air traffic was predicted by IATA to rise from a quarter in 1993 to over half by 2000. Japan was particularly attractive for the US in that the total passenger traffic between Japan and the US increased from 101,505 in 1990 to 160,583 in 1999 (Endo, 2007) (Table 8.4), which was one of the biggest and most profitable businesses for US carriers. In addition, the US saw the potential of intra-Asia traffic where Japanese travel had increased by more than 10 percent till 1997 (Economist, August, 1997). The US estimated that the prospective deal would mean an additional \$4 billion in revenues for the US airlines over the following 4 years and save the US passengers \$1.2 billion as a result of greater competition and increase in frequencies (Lord and Noah, 1998).

Table 8.4 Total passenger traffic between Japan and the US from 1990 to 1999.

	Traffic from Japan to the US		Traffic from the US to Japan	
	1990	1999	1990	1999
1	8,231	14,412	22,070	31,834
2	12,411	18,380	16,457	27,090
3	8,103	12,192	17,230	31,632
4	2,300	3,960	14,703	21,083
Total	31,045	48,944	70,460	111,639

Source: adapted from Endo (2007).

(Remarks: No.1 refers to both US and Japanese citizens taking US and Japanese carriers. No.2 is US and Japanese citizens taking foreign carriers. No.3 is the traffic of

foreign citizens taking foreign carriers, while No. 4 is the traffic of foreign citizens taking US and Japanese carriers).

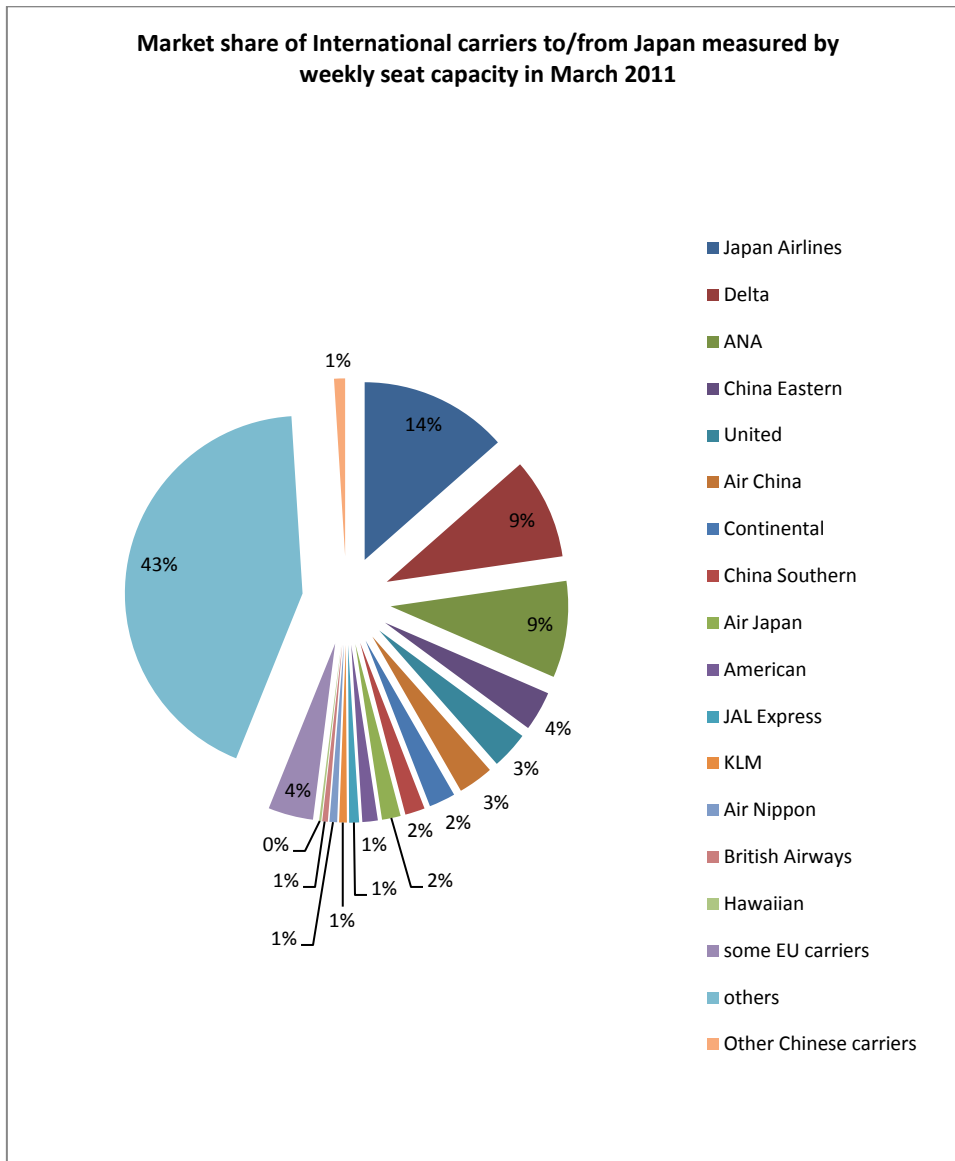
However, the liberalized proposal was rejected by the Japanese government, which was concerned that the Japanese carriers would not receive the same treatment as the US do in Japanese/Asian market, nor were they able to take advantage of the relaxed arrangements to optimize their operations in the US/North American market. The hard negotiation ended up with a compromise that allowed the US carriers to increase frequencies to Japan and the Japanese airlines to have more gateways into the US. Although more carriers such as American, Delta, Continental and UPS from the US side and All Nippon Airways (ANA), Nippon Cargo and Japan Airlines System (JAS) from the Japanese side were able to enter into the market, such an arrangement still resulted in the disappointment of other US carriers such as Northwest, which carried the most traffic between the countries but failed to implement its strategies to leverage Japan as a bus-stop to pick up traffic to further and beyond destinations in the region (Economist, June 1997).

The US carriers were capable of expanding their regional networks to cover more points in the rest of the Asian countries by optimizing their traffic rights entitlement in Tokyo and Osaka. Statistics showed that more than 2.3 million passengers travelled on intra-regional routes including Asia and Oceania via Tokyo as 5th freedom traffic, accounting for 24 percent of the total intra-regional traffic handled at Narita airport (Oum and Lee, 2002). The US carriers were able to capture 20 percent of the lucrative Tokyo-Hong Kong market, with their total market share in Asia increasing from 58 percent in 1986 to over 70 percent in the 1990s.

Another decade of hard negotiation eventually brought about the US-Japan Open Skies deal in October 2010, the long-standing goal the US eventually achieved (Centre for Asia Pacific Aviation, 2009). The deal erased limits on the number of flights, designation and capacity between the two countries (Cooper and Matsuda, 2010) and allowed unlimited opportunities for cooperative marketing arrangements, such as codeshare, and enabled the carriers of both sides to apply for anti-trust immunity. The deal would allow carriers to work “more closely in setting fares, arranging flight

schedules and routes, and coordinating on cost savings through increasing codeshare flights and other operational methods”, as elaborated by Tokyo-based Japan Aviation Management Research (Taipei times, 2010). In addition, the US carriers were guaranteed access to Tokyo’s Haneda Airport for the first time in the 30-plus years that it had been closed to US carriers. As a consequence, Delta, American and Hawaiian Airlines were able to launch their long-awaited Japan-bound passenger services, with UPS and Polar Air Cargo expanding their freight services. According to the analysis of the Centre for Asia Pacific Aviation, data available in March 2011 showed that JAL operated 792 international flights per week with 199,078 seats, while ANA flew 541 weekly international frequencies with 129,281 seats. However, the two only accounted for 22.3 percent of the total international capacity to/from Japan. In contrast, Delta, after taking over Northwest in 2008, which had a hub in Tokyo for its Asia-Pacific operations, operated 508 weekly flights with 135,944 seats, making itself Japan’s second biggest international carrier. Together with others, the US carriers managed to take 14 percent market share. Of the 8 Chinese carriers, China Eastern offered around 52,480 seats per week ranking the 7th in the league (Figure 8.6).

Figure 8.6 Market share of international flights to/from Japan measured by weekly seat capacity in March 2011.



Source: www.centreforaviation.com

8.3.3.3.2 US-South Korea “Open Skies”

The US and South Korea concluded their ASA in April 1957. The MOU signed in September 1978 removed the restrictions on designation and pricing, allowing multiple airlines to operate both scheduled and charter services between the two countries with the freedom of setting fares based on commercial considerations with minimum intervention from the governments. The MOU also agreed that Korean carriers could

operate to the US via points in Japan and that US carriers could serve the Korean market and beyond points via intermediate points. Following the adoption of 1990's "Guidelines of Supervision and Development of the Multiple National Carriers" which enabled the accommodation of the interests of both KAL and Asiana in their international expansion under the constraints of bilateralism, the Korean government agreed to revise the Korean-US ASA once again in June 1991, which eliminated the constraints on route designation and pricing control, thus creating a pro-competitive bilateral environment between the two countries.

South Korea has essentially granted unlimited 5th freedom traffic rights to the US carriers. In exchange, the US allowed Korean carriers to increase their US entry points, access to cargo terminals and ground services (Oum and Lee, 2002). The Open Skies agreement was eventually concluded in June 1998, permitting unrestricted air services by the airlines of both countries to be operated between and beyond the other's territory, eliminating all the restrictions with respect to flight frequencies, routing, destinations and pricing (Oum and Lee, 2002).

Having aggressively promoted air transport liberalization, South Korea hopes that its efforts will help to strengthen its regional hubbing status and enhance the competitiveness of its industry. With its successful conclusion of open arrangements with Japan, another key air transport market in Asia Pacific, and more relaxed arrangements with China with respect to the operations to Shandong Province where South Korea has majority of its investments, South Korea was able to take the advantage it has gained through such arrangements and attract traffic between China and the US market, hence generating significant pressure on the Chinese side which is keen to promote its airports in Beijing and Shanghai and on those megacarriers that are also serving the China-Korea, China-Japan, and China-US markets.

8.3.3.3.3 US-Hong Kong SAR Open Skies

As a Special Administrative Region (SAR) of China after 1997, Hong Kong was authorized to negotiate its own bilateral agreements with any third country, though this would have to be agreed to by the central Government. This principle applies to air transport arrangements. The 2002 accord with the US following 3 years of discussions

allowed US carriers to have 5th freedom traffic rights at Hong Kong, enabling them to operate 58 frequencies per week to Japan, South Korea and other Southeast Asian countries and regions, including the Philippines, Thailand and Taiwan, as well as to carry freight to the rest of the world, though excluding Australia and Japan. Notwithstanding the strong opposition of Cathay Pacific, which complained that the relaxation only gave favourable consideration to US airlines without considering Cathay's request to fly to South America and Europe via the US (www.asiatimes.com), the Hong Kong SAR sealed the deal with the central Government's acknowledgement. This was an indication that China was getting ready for the move towards embracing relaxed air transport agreements that were not necessarily in favour of its own industry.

8.3.3.4 Impact on China's international air transport policymaking

Northeast Asian integration lags far behind that in Southeast Asia, though there is no shortage of interest in forging closer regional ties (Ruan, 2006). Among the three countries, South Korea takes a more progressive approach in terms of trade liberalization though placing less emphasis on economic cooperation (Aggarwal and Lee, 2011). It is one of the few major economies to enter into a Free Trade Agreement (FTA) with the US, which it alleged to eliminate 99.7 percent of its existing tariffs. Japan, on the other hand, tends to conclude asymmetric agreements by making fewer concessions vis-à-vis its FTA partners. As it has a clear preference for enhancing economic partnership that goes well beyond trade liberalization, Japan seeks to incorporate provisions about intellectual property rights, financial services and investment into an all-embracing package (Aggarwal and Lee 2011). In contrast, China prefers a narrow and simple FTA in terms of scope and coverage so as to reflect its under-developed regulatory framework in certain industries. It restricts trade liberalization primarily to trade in goods by excluding provisions or delaying liberalization in services (Aggarwal and Lee, 2011).

The call for an open Northeast Asia area not only came from countries such as South Korea, but also from academics such as Oum and Lee (2002), who suggested creating a "Regional Trade and Transport Facilitation Committee", namely a China-Korea-Japan trading block, which could be used as a platform to negotiate compromised agreements

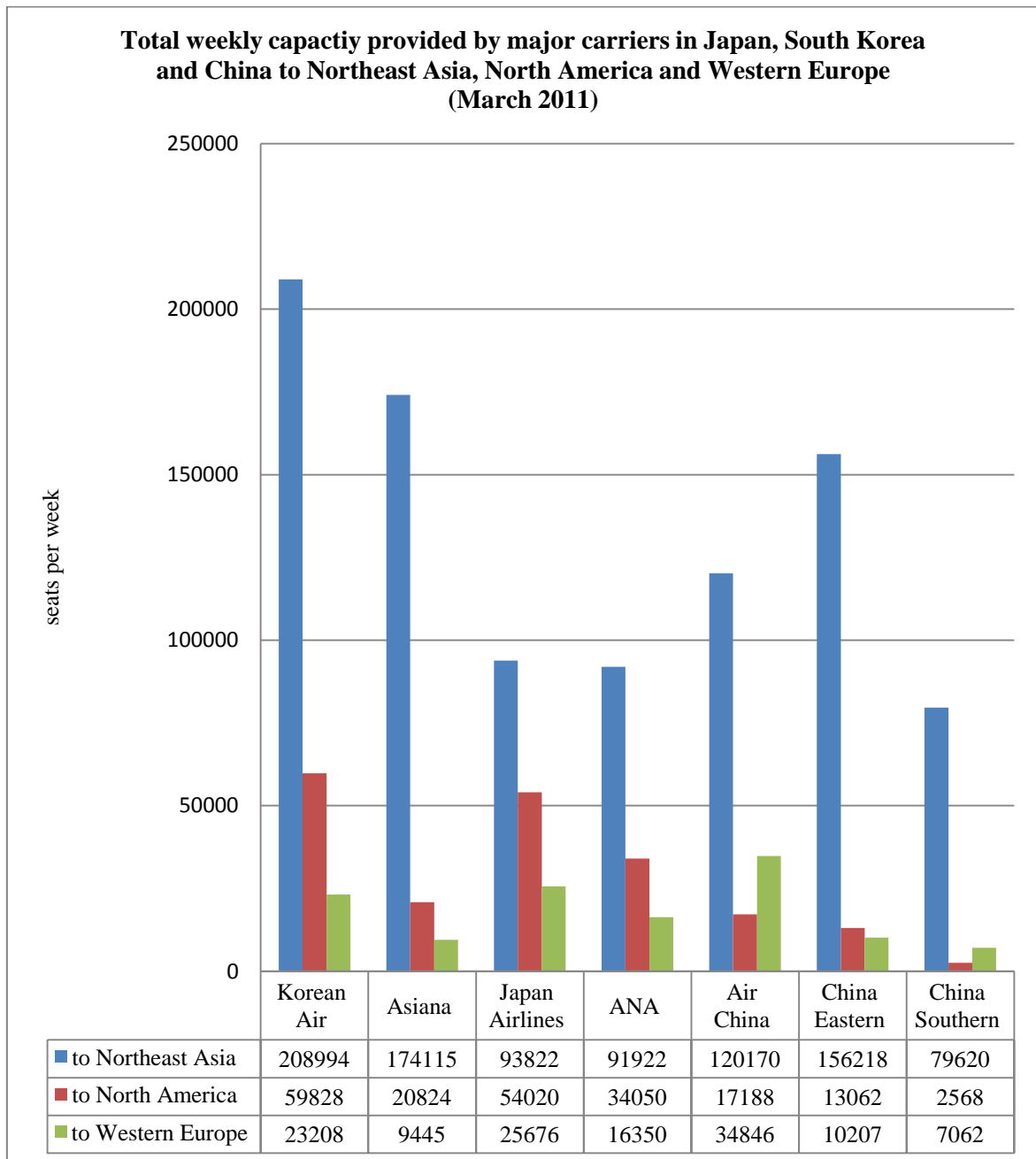
to cover the trade and transport fields, since the senior officials and experts of the Committee would be in a better position to balance the trade-offs with each other. Tactical measures have been suggested to deal with countries like China which tends to be protective of its industry and action plans have been proposed including provision of incentive systems, involving consumers, and making use of other ad hoc measures such as appointing special envoys to represent each government to negotiate the agreements (Oum and Lee, 2002).

The Japan-China-Korea Cooperation was initially launched in 1999 with the primary objective being to facilitate the coordination and realization of various cooperative projects to promote free and fair trade for mutual economic benefits. The Joint Declaration on the Promotion of Tripartite Cooperation between the Republic of Korea, Japan and China in October 2003 helped to speed up the collaboration. Over the years, 17 Ministerial Meetings as well as over 50 exchange programs and dialogues have been held, which have significantly enhanced the cooperation between the three parties in various fields including transport and logistics. In September 2006, the first Trilateral Ministerial Conference on Maritime Transport and Logistics was held, with a Joint Statement of the Japan-China-Korea Ministerial Conference on Maritime Transport and Logistics and two attachments (the Framework of the China-Japan-Korea Ministerial Conference on Maritime Transport and Logistics and the Plan of Action for the China-Japan-Korea Ministerial Conference on Maritime Transport and Logistics) being released (www.mofa.go.jp). The aim was to promote a secure, efficient, cost-effective and seamless logistics system in Northeast Asia.

Air transport has been excluded in this mechanism due to its complexity in negotiating bilateral agreements under the Chicago regime. However, the ASEAN plus Three mechanism as well as the bilateral senior level forum and dialogue have lent momentum to the three parties, which have been actively pursuing the possibility of establishing a more relaxed regulatory and operational environment within the region. The interdependent economies and the trade with each other have laid good foundations for further negotiation for a liberalized environment, which is anticipated to be achieved under the regime of a Northeast Asia Free Trade Area (NAFTA), so as to allow Member States to enjoy more favourable trade and investment conditions.

Despite lacking a regional forum to discuss the air transport arrangements trilaterally, the agreements reached with each other are very relaxed allowing multiple designations, codeshare arrangements and flexible pricing arrangements. As a consequence, air traffic between the three countries has been growing remarkably in spite of the external uncertainties such as the Asian financial crisis in 1997, SARS in 2003 and sluggish performance of the Japanese economy. Major carriers such as JAL, Korean Air and China Eastern have invested more than two thirds of their international capacity into the region to capture the market demand (Figure 8.7).

Figure 8.7 Comparison of the total weekly capacity offered by major carriers in Japan, South Korea and China to Northeast Asia, North America and Western Europe (March 2011).



Source: Centre for Aviation and Innovata

Such liberalised arrangements, on the one hand, satisfied the demand for business and leisure travel as well as bilateral trade, while on the other hand, gave birth to opportunities for airlines in Japan and South Korea to grab traffic between China and

the US. Historically, Japan has always been involved in the Sino-US market. Carriers of both China and the US had been allowed to use airports in Japan such as Tokyo Narita as intermediate points between the two countries though without commercial traffic rights until 1995, when the Arctic route was opened for direct operations. Allowing US carriers to establish a regional hub in Japan has enabled them to have a wider access to Asia Pacific market including China. For South Korea, although the country has not been included in the route schedules between China and the US, the relaxed arrangements between South Korea and China, and between South Korea and the US have enabled Korean airlines to take advantage of such arrangements. They were able to fly more traffic between China and the US via their home hubs, as John Jackson, Korean Air's North America Marketing Director noted that "US carriers cannot expand their frequencies like this (near doubling of Korean Air flights) due to the limited traffic rights. We have Open Skies with China and an enormous North American network. This gives us an edge and supports our goal of becoming the preferred airline to China" (Steinberg, 2007). Permitting carriers of Japan and South Korea to fly to a handful of secondary airports in China enabled them to optimise their traffic rights to feed their hub operations such as at Tokyo and Incheon, contributing a proportional amount of traffic between China and the US. The convenient transit connection provided to passengers destined to both China and the US and beyond points, thus, diluted the attractiveness of Chinese operations in Chinese airports such as Beijing, Shanghai and Guangzhou.

Wolf (2001) argued that regulation of an air transport market generates spill-over effects to other markets that are interconnected by route networks. Traffic diversion benefits countries which have already liberalized their air transport links not only on routes that are substitutes for the regulated one within the same market, but also in other markets. Consequently, a country that still executes regulation in the presence of liberalized interconnected markets runs the risk that its air transport links degenerate to merely spokes of hub operations which are located in other countries (Wolf, 2001). The impact of this kind of traffic diversion is not only on airlines and airports but also on governments, as airlines are struggling to maintain their levels of traffic to achieve economies of scale, airports are threatened to lose their hub status, and governments are

concerned about the competitiveness of their aviation industries compared with their counterparts.

The case of the China-Japan-South Korea-US relationship in the Sino-US air transport market reflects the above proposition. The Open Skies arrangements between the US and Chinese peripheral economies and between Japan and South Korea, which was concluded in August 2007 that lifted restrictions on frequencies, capacity and destinations between the two countries, though with the exception of the congested Tokyo airports, have exerted significant pressure on the Chinese government, airlines and airports. For the Chinese government, it is concerned how its major carriers will compete with their rivals in the region. It faces pressure from such major airports as Beijing, Shanghai and Guangzhou demanding more liberalized arrangements. It understands that relaxing the economic restrictions is inevitable but the key issue remains how quickly the market should be relaxed. In the case of the bilateral discussions in the 1980s and 1990s when the concept of “Open Skies” had only just started to be picked up in Asia, China did not see the necessity for a liberalised environment for its businesses, being convinced that intervention was imperative to guide the country through adverse economic cycles, such as the financial turmoil experienced in Southeast Asia in 1997. While in the 21st century, Open Skies has become a main theme in every bilateral negotiation, the consideration is not whether to acknowledge it or not, but to what extent it should be accepted. For airlines, they are disadvantaged in developing their hubs at their home bases to extend their networks, losing both direct and indirect traffic due to the connecting passenger traffic at third countries’ hub airports. Statistics showed that around 16 percent of US-China passenger traffic in 2006 was lost to third country carriers (Steinberg, 2007). For airports, especially major airports such as Beijing, Shanghai and Guangzhou, they experienced less demand from connecting passengers as a result of their insufficient network coverage. Their strategic objective of being the key hubs in the Asia Pacific region is at stake.

Before the Sino-US negotiations in 2004 and 2007, Chinese airports presented a strong business case pointing out that they had experienced a moderate growth in terms of direct traffic between China and the US, with a proportion of their direct traffic taken

away by their Korean/Japanese counterparts. They faced the risk of losing the battle to be major hubs in Asia to Incheon, as a result of being unable to capture the Sino-US market. The message was acknowledged by CAAC, which noted that one of the objectives in relaxing the Sino-US market was to counter the competition from Korean and Japanese carriers, which have taken advantages of 5th and 6th traffic rights enabled by the Open Skies arrangements between themselves and the US.

To summarise, liberalized arrangements between China's peripheral states and the US, between themselves, and between China and its neighbours have had a significant impact on China's international air transport policymaking. Such an impact, though, is more on policies with respect to the specific country-pair markets rather than the overall national liberalization policy initiatives. This has been reflected in the arguments presented by Chinese interest groups (discussed in the following sections of this chapter) before each round of discussions, especially between China and the US.

8.3.4 Factors at the bilateral level

Foreign governments are more or less traditional actors in foreign economic policy making, often exerting direct influence through bilateral talks and negotiations (Feng, 2006). The degree of influence is largely determined by the two countries' positions in the international system, as well as their relative political power and economic dependency (Feng, 2006). One country's political policy towards the other will be reflected in their bilateral trade talks with negotiation outcomes bearing trade-offs with political significance. The following examines the bilateral relations between China and the US, the Netherlands and the UK, and analyses the impact of political and economic relations on China's international air transport policymaking, in particular, the country-specific policy.

8.3.4.1 China-US relations

Lampton (2001) quoted a well-known Chinese idiom to describe the relationship between the US and China as "same bed, different dreams". He further explained that the processes of economic and information globalization, along with the development of international regimes and multilateral organisations, have landed America and China

increasingly near one another in the same global bed, but their respective national institutions, interests, leadership and popular perceptions, and the very characters of the people, ensure that the two nations have substantially different dreams. Such an underlying dynamic has been the theme since the first decades of post-war US-China relations and will continue to be so well into the twenty-first century (Lampton, 2001). Such a dynamic posts significant challenges for both countries as to how to manage diplomacy in areas such as political, military and economic relations.

8.3.4.1.1 China's view towards the US

When the new China was established in 1949, the nation was not recognized by most of the member states in the United Nations, including the US. Like other world leaders who held a bipolar perception of the international system headed by the US and the Soviet Union, China regarded the US as a threat to its security and adopted a “leaning to one side” policy, choosing to form a “Sino-Soviet long-term relationship” so as to deter the threat from the US. However, the Sino-Soviet relationship broke up in the early 1960s, leaving China to pursue an independent position from both superpowers until 1978, when China and the US reproached their diplomatic ties. Since then, China's US policy has changed from “pro-US” in the 1980s to “multipolarity” in the 1990s and “unipolarity” in the 21st century (He, 2009).

8.3.4.1.2 Sino-US political relations and Strategic Economic Dialogue (SED)

The debate within the US has been endless as to what is the most appropriate China policy, which always gains momentum with each new presidential election (Garrison, 2005). The US's China policy has evolved over the years with each newly-elected president, who will choose the strategy and tactics that suits the overall national interest, though engagement with China has been a consistent and patient theme (Shi, 2009).

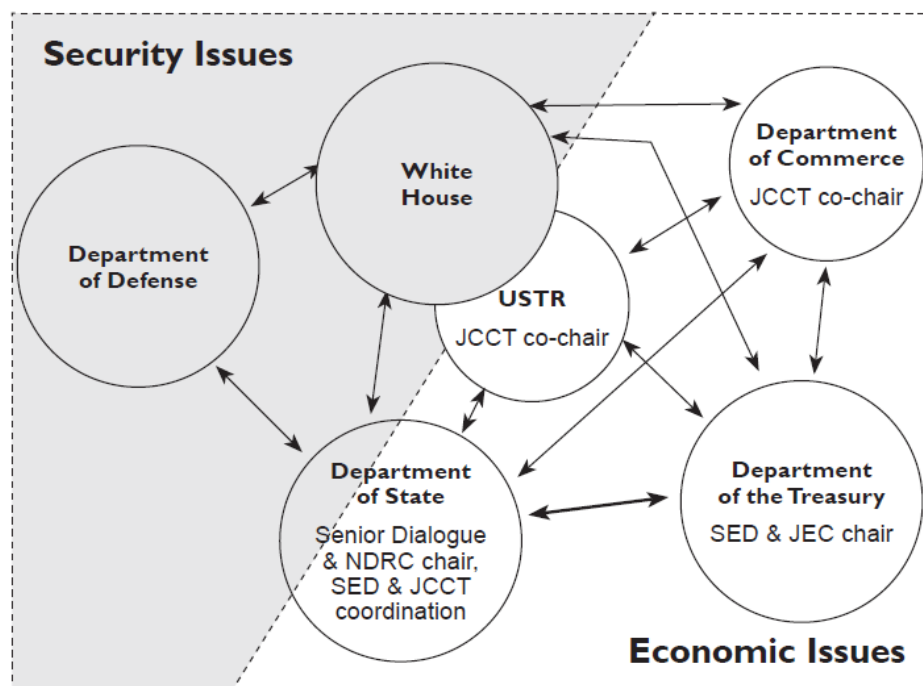
Khalilzad (1999) explained that US engagement, in principle, seeks to maintain and enhance relations with China as much as possible in the various policy realms. It is a tactic rather than a policy as it refers to the means—increased contact and a dense network of relationships—rather than the objectives, though it helps achieve certain objectives. The view holds that deepening China's economic links with the outside world and increasing its foreign trade and investment are the best guarantees of China's

stability and will facilitate China's democratization, thus it is less likely to come into conflict with the US. The engagement policy has had a great impact on Sino-US air transport relations, which have been progressing slowly but steadily over the years towards full and complete "Open Skies".

As a result of the political and legal system, the US's China policy coordination mechanism had been diffused in large part due to the different focus and attention of different institutions before 2006. For example, the DoS, Department of Treasury (DoF), the DoC had all been involved in dealing with China on different economic issues, which had shaped development of different strands of the US's China policy by engaging in a series of contentious economic dialogues under their own authority (Figure 8.8) (Garrison, 2007).

Figure 8.8 Interaction of US stakeholders in US-China bilateral dialogue.

Interactions of U.S. Stakeholders in U.S.-China Bilateral Dialogue



Note: Circle size represents relative importance and influence in dialogue.

Source: Garrison, 2007.

To centralize management across the various bureaucracies involved in the complex relationship, the SED was jointly launched in 2006 by Bush and his Chinese counterpart Hu Jintao, with an aim of enhancing mutual understanding by engaging top level officials in direct and regular dialogue to discuss any political, economic, environmental, trade and cultural issues of mutual concern by better coordinating those well-established bilateral dialogues such as the Joint Economic Commission (JEC) and the Joint Commission on Commerce and Trade (JCCT) (Garrison, 2007). Convened semi-annually and led by the Secretary of the Treasury on the US side and a Vice Premier on the China side, 6 rounds of SED dialogues had been held by 2008 with 189 agreements reached. In the 5th round of SED dialogue alone in early 2008, 40 agreements were concluded (Diao and Li, 2008). Being considered as a positive force not only for economic ties but also for movement on many other bilateral issues, it has been heralded by the Chinese side as a constructive means of communicating intersecting interests, bypassing bureaucracies, building relationships and avoiding megaphone diplomacy (Shi, 2009). Likewise, it was regarded by the US as an effective way to maintain dialogues between top-level officials to lessen the misperceptions and miscommunications for a very productive bilateral relationship. The SED mechanism has helped keep relations progressing and move forward during tough times, and helped both sides to manage tensions that inevitably occurred (Paulson, 2008).

Seeing the benefits of face-to-face dialogue which was able to address the economic differences at a political level, the Obama Administration re-launched the existing mechanism, re-branding it as the Strategic and Economic Dialogue (S&ED), aiming at building a positive, cooperative and comprehensive relationship for the 21st century (www.state.gov) by providing a senior-level forum for direct communications between the two parties to meld the economic and security aspects of America's China policy into one coordinated joint effort (Rogin, 2010). Held annually in both China and the US, the S&ED, the dialogue enables both parties to address all matters of mutual concern, such as climate and energy, which is "an economic issue, a diplomatic issue, a development issue, an energy issue, an environmental issue, an agricultural issue and a national security issue...in its full complexity" (Clinton, 2009). Air transport was first included in the SED in 2007. Although negotiations on bilateral air services between the competent authorities are not necessarily scheduled at the same time as S&ED, both

sides work under the regime of S&ED with any conclusions of the agreements resulting from the discussions being timed to fit into the S&ED programme.

8.3.4.1.3 US-China Aviation Cooperation Program (ACP)

Economic aid is regarded as an instrument to foreign policy, with the political relationship being one of the most important determinants of the aid flows (Radelet, 2006). Providing capital and technical assistance is believed to be an effective weapon in the ideological war to help win those uncommitted nations that are also underdeveloped and poor (Friedman, 1995). Greater contributions from developed nations must be linked to greater responsibility from developing nations (Lancaster, 2007). Firmly believing in this philosophy, since the Cold War, the US has been one of the major aid donors to developing countries, though it was criticized for giving little regard as to whether the aid actually was used to support development (Radelet, 2006). In 2002, the Bush Administration announced an unprecedented amount of aid totalling \$5 billion for development to be achieved by 2006, arguing that it was a new compact for global development defined by new accountability for both rich and poor. The elevation of development has since become one of the three priorities of US foreign policy, along with defense and promoting democracy (Lancaster, 2007).

The US-China Aviation Cooperation Programme (ACP) was created in 2004 with the primary objective being to promote technical, policy and commercial cooperation between the aviation sectors of the two countries (www.ustda.gov). Through the cooperation of CAAC and several US Government agencies including the United States Trade and Development Agency (USTDA), FAA, DoC, the US Embassy in China, as well as its 36 prominent members such as Boeing and General Electric Company (GE), this innovative public-private initiative is designed to link the US and Chinese governments and aviation industries in a multi-faceted programme so as to create an enabling environment to advance US commercial interests that will benefit US exports of aviation products and services.

Over the last six years, a total of over \$5.5 million has been invested to sponsor a wide range of projects including months-long training for executives, visits to the US, symposiums and seminars, safety and security projects, as well as airports

environmental best practice projects. One of the key efforts is a “game-changing program”, the Executive Management Development Training (EMDT), which provides four-months cutting-edge training for senior managers coming from CAAC’s economic regulation divisions, airlines and airports (Tymcyszyn and Bai, 2009), with one of the key subject matters covered being the US liberalization experience and what lessons China could learn. The objective is to expose the trainees who are promising future leaders to the best US aviation practices, procedures and technologies, thus helping China establish a framework for managing the challenge of its continued growth of the aviation sector, with Reimold (2009) claiming that “it is important to remember when it comes to aviation cooperation, it is not just about technologies and procedures, it is about people. Through the EMDT programs, we believed that we have taken an important step towards improving our working relationships with the next generation of aviation leaders”.

Other beneficiaries include China Eastern, which was funded for its staff training; CAAC Air Traffic Management Bureau (ATMB) whose executives are trained with respect to safety and general management; Beijing Airport, which will work together with US professionals on construction of its second airport to ensure an environmental-friendly project; and other Chinese airports, which would be familiarized with US best practices in sustainable airport development by making a trade mission to visit US airports such as Washington, New York, Chicago O’Hare and Atlanta.

In commenting on the progress and achievements made through the ACP, the USTDA Acting Director Leocadia I. Zak stated that "environmental solutions and technologies are critical to sustainable growth in the aviation sector. Working in cooperation with our Government partners and the US and Chinese civil aviation industries, we are helping our aviation systems grow together in mutually beneficial ways. By sharing experiences and best practices with each other, we can achieve results that will strengthen our respective systems and shape the future of commercial aviation" (USTDA, 2009).

8.3.4.2 Impacts on China and Sino-US negotiations

Sino-US relations are the most important relationship for both countries. From China’s perspective, the US is not only the world leader politically and economically but also

the country's second biggest trade partner. It holds the most advanced technology that China needs for its continuous economic growth. For the US, China represents an emerging market with vast potential for US business, and a vital player in maintaining the world economic order. It also holds a strategic key to maintain a military balance in East Asia, such as addressing issues in North Korea. However, such an understanding does not mean that both have developed a shared view towards each other and the rest of the world. On the contrary, the two still perceive totally different priorities, dangers and strategies when contemplating how best to deal with each other (Cohen et al, 2003). No theories, precedent, or economic econometric equation is available for either of them to define what is its respective national interest and how to ensure that policy outcome would serve the country's interest best. Conflicting value judgments still need to be reconciled by all those that are involved in the policymaking process (Cohen et al, 2003).

Sino-US political relations have had a great impact on the negotiation results of Sino-US air transport arrangements. As Chapter 6 reveals, the bilateral air transport relationship was formulated immediately after the two countries established diplomatic ties in the early 1980s. For the following ten years, there were few discussions held mainly due to the distant relationship with each other. Political and trade tensions developed since 1980s could be cited to explain why the two failed to pursue further for a closer relationship. The first abrupt relaxation came in 1999, almost 20 years after the bilateral ASA was signed, when China was preparing to be admitted to the WTO, to which the US held the key for its accession. China publicly announced that it was prepared to offer substantial concessions such as eliminating market entry barriers and called for all industries to take actions in this regard. The next biggest jump to a liberalized arrangement took place in 2004, three years after China's entry into the WTO. Sino-US political relations had been significantly improved after the 9.11 event, with the two countries declaring to be strategic partners. Regular summits have since been held at very senior levels with an aim of forging a strong link between the decision makers through a continuous and direct dialogue. Though political forum/summit is a new phenomenon in the political economy that has only come into existence since the 21st century, they have played a key role in strengthening the bilateral relationship by facilitating the communication for an extensive engagement with each other. This was

particularly attractive for those countries who wanted to develop further their relationship with China, as “guanxi”, namely personal relationship, is regarded as the key to securing business success in the Chinese market.

The Sino-US SED/S&ED was created with such an aim. The US is fully aware of the importance of personal relationships in Chinese business practice and the SED/S&ED is specially designed to provide a forum for senior officials to meet regularly to discuss any issues that cannot be resolved at junior level. When air transport has been brought under the mechanism of the SED, the US aims at achieving a breakthrough of what it failed to achieve at industry level, as Paulson (2008) observed. In April 2006, meetings to discuss how to develop air transport services commenced. While the US side wanted to have a full open skies arrangement involving unlimited designation of carriers and unlimited cargo operations, China was convinced that it did not want such a deal at this stage due to its insufficient infrastructure and the unused traffic rights available for Chinese carriers from the 2004 Protocol. The discussions did not progress due to the differences between the two parties. However, things started to get moving again when Paulson brought the case to his Chinese counterpart Madam WU Yi who co-chaired the third round of the SED, which resulted in the successful conclusion of 2007 Protocol. The Protocol eliminated all restrictions on the number of cargo airlines and flights, thereby allowing all-cargo airlines to optimise their global route networks. Agreement was also reached on doubling the permissible market capacity and removing restrictions on Chinese carriers that could enter the market. What is more significant is that both parties agreed that discussions about full Open Skies arrangements should start no later than March 2010. Paulson recalled in 2008 that “lower-level negotiations on such (bilateral air services) an agreement had been stalled for some time because China was focused on developing the competitiveness of its domestic aviation industry and limiting international competition. But through the SED, I brought this issue to the attention of my counterpart, then Vice Premier Wu Yi, and explained how the increased exchanges of people and goods between our two countries would strengthen the relationship. Thanks to the agreement, US passenger flights to and from China will more than double by 2012, and air-cargo companies from both countries will enjoy full liberalisation of the industry, including the lifting of restrictions on the frequency and price of flights, by 2011” (Paulson, 2008).

In terms of the CAP program, although to date direct influence on China's air transport policy is not observable, the impact on the ideology of CAAC officials could be long-term and more fundamental. Outside ideas could lead to a shift in the dominant thinking of decision makers, influence their beliefs and behaviours, and ultimately their policies choices, as Feng (2006) claimed. They will also shape their values on society, the culture and even their practice, resulting in the challenging of existing norms. Williams (2009) observed that the brainwashing efforts of the US seemed to have paid back. CAAC is more inclined to accept the working procedures and business practices of the US and endeavours to replicate these to fit China's circumstances. The relationship between the Chinese Ministry of Transportation (MoT) and CAAC, which has been an affiliated bureau since 2008, will eventually replicate to some degree the US aviation management system as reflected in the fact that there are, at the current time, a number of ongoing advisory roles being played in China by the US DoT and FAA.

8.3.4.3 Sino-EU political relations

8.3.4.3.1 The EU's China policy

Over the years, the EU has developed an intricate web of interregional and bilateral contact covering political and commercial relations with almost every country in the world by having seconded over 100 diplomatic missions and offices around the world with a high profile and considerable economic weight (Dinan, 1999). Although the US has always been carrying the most weight for the EU's external relations given its size, economy and the importance in the world order, the EU recently has given priority to emerging economies including China.

Unlike the US, whose foreign policy is affected by the president elected in office, the EU's foreign policy is formulated by the European Commission, the supranational institution claiming to represent the interests of all individual Member States. The EU's foreign policy is usually announced through the Commission's communications, where the justification of policy direction and implementation strategies is spelled out. Since 1995, four such China Policy papers have been published which have served as guidelines for the EU's strategy towards China.

The first EU China Policy, “A long-term policy for China-Europe Relations”, was announced in July 1995 (Dinan, 1999), as part of the key components of its new strategy towards Asia. By that time, China had become the EU’s 4th largest export market and 4th largest supplier. China’s further reform and liberalisation was promising in providing more trade and foreign investment opportunities which the EU had been striving to support its businesses to achieve. To this end and to help raise the EU’s international profile, the EU recognised the need to redefine its relationship with China, with whom a long-term relationship should be maintained for a “constructive engagement” to appreciate China’s unprecedented economic upsurge (Casarini, 2006). Although the policy was very basic, it has laid a good foundation for the Commission to drive the relationship with China in a single integrated framework at Community level. China responded actively to the EU’s call with its President Jiang Zemin making his historical trip to Western Europe in the same year and calling for the development of a stable, friendly and long-term cooperative relationship (Zhang and Zhuang, 2005).

The EU’s second China Policy, “Building a comprehensive partnership with China”, was released in 1998 which was regarded a milestone in EU-China history. Recognising that China’s emergence as an increasingly confident world power was of immense historic significance to both Europe and the international community, the Commission called for an update of its China policy in response to the challenges posed by the changes in China. Accordingly, a further engagement with China through an upgraded political dialogue in the international community (Men, 2007) should be achieved and EU-China relations should be upgraded to the same level as those of EU-US, EU-Russia and EU-Japan (Zhang and Zhuang, 2005). As a result of the political drive, the first bilateral Summit Meeting was held in London in April 1998 with a joint statement announced, declaring that China and the EU would “establish a long-term, stable and constructive partnership oriented towards the 21st century” (Zhang and Zhuang, 2005). An annual Summit Meeting mechanism was thus established to facilitate the development of relations.

The partnership was enhanced in September 2003 with a third China Policy, “A maturing partnership: shared interests and challenges in EU-China relations”, being published to cover the years from 2003 to 2006. Recognising China’s growing

importance in world politics and economy, the EU realised that an outspoken comprehensive China Strategy was required in order to define the objectives and determine the actions and measures for effective implementation. A comprehensive, independent and consistent long-term strategy was thus formulated emphasizing shared interests not only in bilateral relations but also in global affairs. It stated that “the EU and China have an ever-greater interest to work together as strategic partners to safeguard and promote sustainable development, peace and stability” (Men, 2007). A total indicative budget of €250 million was envisaged for the five year period covering various projects and activities in different sectors, such as human resource management, environment and sustainable management (Council of the European Union, 2006).

The EU’s fourth China Policy, namely, “EU-China: Closer partners, growing responsibilities” was spelled out in 2006 in the Commission’s Communication to the Council and the European Parliament, in which the Commission explicitly proposed that a dynamic relationship with China was needed to allow leverage based on the values of the EU (Council of the European Union, 2006). The EU should continue to support China’s internal political and economic reform process for a strong and stable China which fully respects fundamental rights and freedoms, protects minorities and guarantees the rule of law. The EU should reinforce its co-operation with China to ensure its sustainable development, pursue a fair and robust trade policy and work to strengthen and add balance to bilateral relations. Co-ordination and joint actions should be increased to improve co-operation with European industry and civil society (Council of the European Union, 2006). A number of key objectives were thus identified, some of which included (Council of the European Union, 2006):

- 1) Supporting China’s transition towards a more open and pluralist society;
- 2) Promoting sustainable development;
- 3) Ensuring secure and sustainable energy supplies;
- 4) Combating climate change and improving the environment;
- 5) Improving exchanges on employment and social issues;

6) Improving co-ordination on international development; and

7) Building sustainable economic growth.

In order for an effective implementation of the policy, a “China Strategy Paper” was published by the Council of Foreign Relations in 2007 to cover the seven-year period from 2007 to 2013. Recognising the “duality” of character of China, namely a developing country in terms of certain traditional indicators on the one hand but a significant player on the world stage in economic and political terms on the other, the EC’s response strategy towards China was adjusted to be targeted at:

1) Providing support for China’s reform programme in areas covered by sectoral dialogues;

2) Assisting China in tackling global concerns and challenges over the environment, energy and climate change; and

3) Supporting China’s human resource development (www.cfr.org).

An indicative funding of €224 million for the period was allocated with the assistance in the areas of intervention being complemented by actions and support to be provided through various thematic programmes and regional budget lines (www.crf.org), with a budget totalling over 20 million Euros to be allocated to civil aviation.

Overall, the EU’s China policy has been quite ambitious and its interest in China encompasses humanitarian and environmental concerns (Dinan, 1999). The EU seeks to promote regional stability and global prosperity by achieving “smooth and gradual integration of China into the world economy”. The Commission and Member States are trying to achieve greater coordination of EU activities and national politics relating to China, and a higher EU profile in China and throughout Asia (Dinan, 1999). The policies published at different times have helped the EU to refine its policy towards China by identifying objectives and proposing the most appropriate implementation strategies which have safeguarded the China-EU relationship over the last three decades.

8.3.4.3.2 China's view towards the EU

Enhancing China-EU relations is an important component of China's foreign policy. The Chinese leaders and scholars believe that the EU holds different views from the US regarding the future of the international order which is quite close to that of Chinese thinking (Wai, 2005). The EU favours multilateralism in addressing international issues by emphasising common interests, sharing of power and abiding by the restrictive common rules of the games (Wai, 2005). From the Chinese point of view, the EU is considered a major actor/partner in the formulation of a new order for the benefits of China. As a strategy to combat the influence of the US, China first put forward its multipolarity policy in the late 1970s. In 1998 when the first EU-China summit was held, China proposed to use the term "multipolarity" in the final joint declaration, which was refused by the British representative who was concerned about misinterpretation from the US side, which might cause unnecessary misunderstanding, thus damaging the already weak relationship between the EU and US across the Atlantic (Men, 2007). Though China chose not to replace the term multipolarity, its denotation was interpreted differently by highlighting the elements of multilateralism such as democratisation of international relations and the strengthening of coordination and dialogue (Men, 2007). In October 2003 as a response to the EU's China Policy Paper, China released its first-ever "EU Policy Paper" outlining plans and measures on bilateral cooperation for the next 5 years.

Recognising the EU as a major force both politically and economically in the world, the Paper stated that the common ground between China and the EU far outweighed the divergent views on certain issues as there existed no fundamental conflict of interest between the two parties (China's EU Policy Paper, 2003). On the contrary, China and the EU were highly complementary economically in that the EU had a developed economy, advanced technology and strong financial resources, while China boasted a steady economic growth, a huge market and abundant labour force. To strengthen and enhance the China-EU relationship, China was committed to a long-term, stable and full partnership with the EU with the following objectives:

- 1) To promote a sound and steady development of China-EU political relations;
- 2) To deepen China-EU economic cooperation and trade; and

- 3) To expand China-EU cultural and people-to-people exchanges.

The Paper identified various fields such as politics, military, economy, education, science, culture, and social and judicial systems to expand the cooperation, with civil aviation being one of the industries that required more collaboration. “China-EU exchanges in civil aviation will be deepened and Chinese and EU enterprises are encouraged to strengthen their cooperation on production, technology, management and training in the aviation sector” (China’s EU Policy Paper, 2003). The Paper called on both sides to make efforts to improve economic relations over the next five years, such as to give play to the mechanism of an economic and trade regulatory joint committee and a stepped-up economic and trade regulatory policy dialogue in order to achieve the objectives of elevating the EU into China’s largest trading and investment partner. All in all, China has given the same importance to its relationship with the EU to that of China-US, thus facilitating the development of a strategic relationship between the two parties.

8.3.4.3.3 The European Union’s influence on China’s air transport policy and on individual Member State’s negotiation

Over the years, China-EU air transport relations have been dominated by bilateral arrangements. Until 2010, almost all air transport negotiations between China and the EU Member States have been mainly conducted at bilateral level rather than at Community level. This is understandable in that the industry has been governed by the bilateral regime from the Chicago Convention which the signatories are bound by. It can also be explained that the European Commission has not yet received the mandate to engage in such negotiations with China though the efforts to obtain such a mandate started in March 2005 (European Commission, 2005).

Following the Open Skies judgment of the ECJ in November 2002, the Commission has been keen to negotiate a horizontal agreement with China, which was identified as one of the key countries to resolve the legal issue. To test how the Chinese would react to such a request, the Commission sent a senior delegation to meet CAAC in China in May 2004 to explore the possibility of negotiating at a Community level to amend the existing ASAs concluded between the Member States and China (www.europa.eu).

Encouraged by CAAC's positive feedback, in March 2005, the Commission requested the Council to authorise a mandate so as to allow it to proceed with a comprehensive OAA with China, arguing that it was time to develop a wider range of opportunities between China and the Community in air transport (European Commission, 2005). A comprehensive mandate was imperative, paramount and mutually beneficial given:

- i) the growing importance of the Chinese aviation market;
- ii) the difficulties encountered by individual Member States in seeking to bring bilateral agreements into conformity with Community law; and
- iii) the benefits of replacing the fragmented European approach in its relations with China with a co-ordinated and liberal approach.

The Commission reiterated that a mandate for negotiating with China would be adequate to reflect the EU's position in the world today and clearly strengthen the negotiating position of the Community to signal its determination to resolve the outstanding infringements of Community law and competence. Supported by the findings of research, the Commission argued that the benefits of opening market access and easing investment rules in China would be similar to that of an EU-US OAA which was able to generate several hundred millions of Euro business per annum.

To convince the Council that the Commission was more competent in negotiating with China, it further spelled out the objectives to be achieved as well as the strategies to be employed in conducting such negotiations. The amended agreement with China, as the Commission suggested, should not be limited to agreeing on Community designation clauses, but establishing an ambitious framework integrating industrial cooperation and wider aviation issues such as co-operation in the fields of aviation safety, security, air traffic management, technology and research, as well as "doing-business" issues (European Commission, 2005). Such a comprehensive scope would enable both parties not only to address the legal issues to ensure a level playing field but also to explore opportunities to foster technical and industrial-wide cooperation (European Commission, 2005).

To ensure that the Chinese side was fully aware of the significance of the amendment of the existing ASAs between EU Member States and China, a second exploratory meeting

was held in Beijing in October the same year with the EU delegation providing a general overview of the development on the negotiation and implementation of the existing ASAs between the EU Member States and third countries. It made it clear to the Chinese side that there was an urgent need to amend such existing ASAs between China and EU Member States to include a community designation clause, without which such agreements would remain vulnerable to legal challenges (European Commission, 2005). The Chinese side replied with caution that internal assessments had been undertaken on the possibilities of solving the outstanding legal issues with clarifications being made relating to the draft horizontal agreement. Instead of committing to engaging in such negotiation with the Community immediately, China only promised to give further consideration to such an agreement.

Further pressure was exerted at the 7th EU-China Summit held in the Hague on 8th December 2004 which was attended by very senior officials including Chinese Premier Wen Jiabao and his team of ministers as well as the President of the European Council, and the Prime Minister of the Netherlands, Mr. Jan Peter Balkenende and his team. Believing that the Summit was the most appropriate venue to inform China of EU's determination to resolve the legal issues in the existing bilateral ASAs, the Commission brought up the issue once again and requested that it should be treated as a priority in order to bring them in conformity with EU law. The call received positive feedback from the Chinese counterpart with a commitment to addressing the issue being recorded in the Joint Statement released on 8th, stating that "the Leaders, in welcoming the dialogue progress and the closer EU-China co-operation in civil aviation, agreed to further deepen co-operation in this field, including civil aviation industry and technology, and to solve as a matter of priority outstanding issues thereby opening the way for a potential future EU-China Aviation Agreement" (Council of the European Union, 2004).

The EU won China's commitment to engaging, as a matter of priority, in formal negotiations of the "horizontal agreement" in the following June, when the first EU-China Aviation Summit was staged in Beijing sponsored by the EU and jointly organised with CAAC. Gathering more than 200 senior government officials including Mr. McMillan, Director General of Civil Aviation of the UK acting as the EU

Presidency at the Summit, and industry professionals, the Summit was considered the best mechanism to draw attention to the necessity for a horizontal agreement at the Community level. In addressing the opening ceremony, Mr. Jacques Barrot, Vice President of the Commission, raised the issue once again by referring to the commitment made by both parties at 2004's 7th EU-China Summit, stressing that it was one of the EU's priorities to ensure that aviation relations were founded on a sound legal basis. Those ASAs with third countries including China that were not in conformity with Community law must be amended in order to provide legal certainty to all operating airlines (Barrot, 2005). He told the Summit that the Council of European Transport Ministers had adopted conclusions in which they agreed on a roadmap for Europe's external aviation policy for the coming years and urged his Chinese counterpart to "take a favourable decision to engage into the exercise shortly" to resolve the issue so that more time and energy could be dedicated to negotiations of a broader, global EU-China agreement (Barrot, 2005). At the meeting between himself and the then CAAC Administrator Yang Yuanyuan on 29th June, the day prior to the official opening of the Summit, both sides expressed the wish to strengthen co-operation, notably through three concrete initiatives, one of which being to take actions to bring those existing bilateral agreements between EU Member States and China in line with the EU law (www.europa.eu).

The following years saw continued communications and negotiations between the EU and CAAC although progress was slow. This was partly because of China's concern about the prospective consequences that might result from the implementation of the amended designation clause (Li, 2009), while on the other hand, the Commission was also aware of the challenges it would have as a consequence of such a comprehensive agreement with China. It fully understood that restrictions on traffic rights might remain under a future Community-China agreement with the need to develop transparent and non-discriminatory procedures for the allocation of such limited traffic rights as negotiated at the Community level (European Commission, 2005). Such a commitment to preparing the procedures of such an allocation and its gradual implementation was not adequate to persuade its Chinese counterpart that the mechanism would not be discriminative to Chinese carriers that were struggling in the China-EU market.

Encouragingly, persistent dialogues between the two parties have brought about a consensus in 2009 with the Commission agreeing with CAAC to continue bilateral negotiations with selected EU Member States to resolve the legal uncertainty under the precondition that a "circumvention clause" is incorporated in the bilateral agreement (Liang, 2010). The agreement between China and the Netherlands reached in March 2010 was a good showcase to demonstrate that with the continuous communication between China and the EU, its member state was able to resolve the legal issue while at the same time relaxing the market entry restrictions through bilateral negotiations. By October 2010, CAAC had successfully completed negotiations with Italy, Belgium, Norway, Sweden, Denmark and Slovakia, and accommodated the EU's requirements for designation and nationality. It is expected that a breakthrough will take place in the first half of 2011, the time that both parties have agreed to engage in negotiations on the horizontal agreement based on the model texts of the above-mentioned bilateral agreements (Liang, 2010).

8.3.4.4 Impacts on Sino-UK and Sino-Netherlands's negotiation

Institutions such as the European Commission at the EU level are supranational organizations that are authorized by its Member States to act on their behalf in certain realms. Such a regime is quite unique in the international system and China, though comfortable in dealing with it, is not comfortable in negotiating with it any kind of commercial arrangements, with one of the biggest concerns being the consequences of treating divergent social and economic systems as one. Holding that bilateral negotiation with an individual country for a country-pair market is the best mechanism to address international air transport issues, China needs to be certain that any arrangements between the country and the Community will not jeopardize its national interest. Whenever possible, the Chinese would avoid negotiating with European interlocutors who are empowered to speak for the EU as a whole, which brought its combined weight to bear (Fox and Godement, 2009). China prefers dealing with national negotiators, a tactical choice that many Member States also preferred which allowed them to exert national control (Fox and Godement, 2009).

From the EU's perspective, its priority over the years since 2002 has been to resolve legal issues in the existing bilateral ASAs. Without a mandate from the Council of Ministers, the EU is not eligible to negotiate such a comprehensive agreement with China, which is more than happy to deal with individual EU Member States. Although EU has developed a policy outlining its goals and objectives in dealing with China, as well as formulated a regime of summits gathering the state heads of its Member States and China on a regular basis, it has failed to produce any substantial consequences to the benefit of the EU because the objectives are seldom followed through due to the steady increase in the number of objectives and competing requirements for urgency (Fox and Godement 2009). The EU's pressure on specific issues tends to come through formal dialogues, which the Chinese side accepts and is engaged in continuation, but unfortunately lead to inconclusive talking shops (Fox and Godement, 2009).

In addition, EU Member States have differing philosophies about how to deal with China despite both the Netherlands and the UK advocating a liberal unrestrictive trade regime (Fox and Godement, 2009). The differences between Member States, while serious, are nowhere near as significant as that between any one of them and China (Fox and Godement, 2009). Their divergent views and me-first strategy in dealing with China has jeopardised a unified EU approach, which has undermined the EU's position in negotiating with China (Fox and Godement, 2009).

Traditionally focusing on international trade and commerce, both the Netherlands and the UK take international air transport relations with China as economic issues and are reluctant in bringing these into the political realm (Knight, 2010). Aviation including international air transport is only a subject that is covered in industry cooperation which does not receive high-profile attention at the summit level. Evidence from the empirical research in the preceding chapters has revealed that neither party has involved any senior officials above ministerial level in the bilateral negotiations, nor are any political figures or mechanism involved in such bilateral negotiations. The respective competent authorities take full responsibility to negotiate at ministerial level, which has proved to be effective and successful in addressing market demand to support bilateral trade.

8.4 Factors at the domestic level

In order to understand how China's international air transport policy is developed, an examination and discussion of the factors from external sources is incomplete, as any foreign policy is to be formulated within a nation, which must reflect the domestic political and economic needs. Innenpolitik theories argue that the survival of domestic regimes and leadership constitutes a basic objective in a nation's foreign policy (Lai, 2010). Specifically, a nation's foreign policy is determined by several sets of domestic factors, which include the following: the preservation of domestic regimes, meeting of economic demands integral to the economic system, the leader's vision for a preferred domestic regime, their political survival and their skills in managing the external-internal relationship (Lai, 2010). In examining domestic factors influencing the free trade policies of East Asian countries such as China, Japan and South Korea, Aggarwal and Lee (2011) identified business firms as another major source. They asserted that the formation of a new trade strategy is usually constrained by conflicting social interests of the firms, whose nature and scope of business dictates their preference for liberalization. They stated that institutions, whether the policymaking authority is centralized or not, make a big difference to the policymaking process leading to different policy outcomes. A centralised policymaking structure is able to coordinate conflicting interests and dissenting views with relative ease so that the government can formulate coherent trade policies and strategies and carry out trade negotiations without serious impediment (Aggarwal and Lee, 2011). Hao (2005), in examining China's policy on the US, established that societal forces at the domestic level have become extremely important in crafting China's policy output. They explained that societal forces are almost a catch-all notion which include a variety of elements such as public opinions, the business community, think tanks, media, technocrats within the bureaucratic apparatus, local governments and other sub-national entities within the Chinese society. With different interests and goals, these factors operate as a loose conglomeration of individual actors and barely coordinated with each other in terms of their views and opinions. However, they together represent a force powerful enough to seek to influence the final policy outcomes in favour of their individual preferences, directly or indirectly, intentionally or unintentionally (Hao and Su, 2005).

With a view of understanding how China's international air transport policymaking is affected from the domestic political perspective, the following provides an intensive analysis by first of all identifying those domestic factors, which is then followed by discussions of how they have influenced the nation's policymaking process and affected the negotiation outcomes. Focus is directed to such variables as the need to meet national economic policy objectives, interest groups including both business communities and local governments, media and bureaucratic institutions.

8.4.1 Air transport as an instrument to support national political and economic objectives

Since 1978, the key objective for the Chinese government has been to pursue economic growth to achieve modernization. In its continuous search for effective strategies for economic prosperity, the Government calls for industries to maximize their capacity to serve the overall objectives of national interest. The need to develop a comprehensive national transportation system including rail, road, waterway, air and pipelines has been an important focus of the country since 1978. Transport is more planned as an infrastructure rather than a service to satisfy the requirements of the expansion of the market economy and the growth of other industries (Williams, 2009). As the demand for domestic and international transport emerged in response to the rising economic expectations, increasing pressure has been built up on the efficiency of the transport system (Williams, 2009). As export has been given priority in driving GDP growth, development of an efficient air transport system has become a major imperative for CAAC.

The first action taken by CAAC was to formulate policies to encourage air transport development in order to facilitate foreign direct investment in the middle of the 1980s. Airlines were approved to be set up in Xiamen (Xiamen Airlines, 1984), Shanghai (Shanghai Airlines, 1985) and Shenzhen (Shenzhen Airlines, 1992), with the local municipal or provincial governments being the biggest shareholders. Airports projects were granted for either construction or expansion in order to accommodate the traffic demand. Airports along the east and south coastline, including Dalian, Tianjin, Qingdao, Yantai, Jinan, Nanjing, Hangzhou, Ningbo, Xiamen, Fuzhou, Shantou and

Shenzhen were allowed for international operations, though mainly to the East and Southeast Asian countries, which significantly improved the connectivity of these cities to the outside world. Xiamen Airlines was licensed for regional operations to destinations in Southeast Asian countries, though under the name of China Southern in the early 1990s, while Shanghai and Shenzhen Airlines were authorized to operate to Southeast and/or East Asian destinations, such as Singapore, Thailand, South Korea and Japan in the 2000s. The second response CAAC gave to the national policy initiative was to support the efforts of Hainan Island in the early 1990s, when the central Government called for the establishment of a SEZ on the island. CAAC approved the formation of Hainan Airlines in 1993 and allowed Haikou and Sanya airports for international operations.

The latest response of CAAC and the industry came in 2000, when the central Government announced a major strategic initiative to develop Central and Western China and to revitalise the Northeast provinces (Figure 8.9). The Government required that all industries gave their support so as to facilitate the process of modernization of these regions through attracting investment and urbanizing key cities. The rationale of the administrative actions was to address the imbalance of material benefits after years of economic growth between the East and West, and South and North. While the South and East is far too developed, the North and West remain under-developed, resulting in one country with many markets (Meyer, 2008). Economic prosperity and improved living standards have been largely enjoyed by coastal residents, especially along the physical parameters of the Beijing-Shanghai-Guangzhou triangle. Recognising the divergence in economic growth and the ever growing gap within the country, the central Government saw the urgent need to develop a coherent national economy so as to minimize the economic and financial gap, stabilize the social order, and eventually enhance China's image as a growing international player. To this end, several policy initiatives, namely the Great Western Development Strategy and the Northeast Regeneration, have been launched with an attempt of driving forward economic growth in these regions. An underlying geopolitical implication was to protect the political integrity of China's national boundaries, where the majority of population has divergent cultural practices and religious beliefs (Williams, 2009).

Figure 8.9 Central, Western and Northeast China.



Remarks:

- The east coast
- Central China
- Northeast China
- China Western Development

Source: www.en.wikipedia.org

CAAC responded to the Government's call by formulating an air transport development strategy to engage in a broad spectrum of activities in key areas including investment in airport construction and expansion projects and the promotion of direct international air links to the regions. Policy is leveraged to give preferential considerations to these areas. For example, CAAC has announced investment of \$6.5 billion for airport projects in Central and Western China for the years 2005 to 2010. Kunming and Chengdu Airports were intended to become regional hubs to serve both China and Southeast Asian countries. Four new airport projects in addition to Lhasa Gonggar airport have been announced in Tibet, which include Qamdo Bamda, Nyingchi, Gunsa and Xigaze Airports. CAAC's statistics showed that the number of airports in the Central and

Western regions increased from 58 in 2000 to 66 in 2005 and is expected to have another 35 new airports by 2020 (www.caac.gov.cn). MOUs were signed between CAAC and provincial governments such as Xinjiang, Yunnan, Jiangxi and Henan to support their efforts in developing more direct international links.

In 2002, the central Government proposed another strategy of “Going Global” that was aimed at encouraging Chinese enterprises to invest overseas, in contrast to the open-door policy that invited foreign capital into Chinese market (Ku, 2006). In order to promote the Going Global policy, several measures were taken such as supporting Chinese business to undertake large-scale projects in key countries in Africa and Southeast Asia. As a response to the central Government’s call, CAAC again demonstrated its full support to this initiative by agreeing liberalized arrangements with its African and Southeast-Asian counterparts. For example, CAAC has removed restrictions on cargo operations on China-African markets and allowed 7th freedom traffic rights operations on passenger/combination services. CAAC also relaxed restrictions on passenger/combination services on selected China-ASEAN country-pair markets, allowing multiple designations including LCCs to enter into Chinese market, which, to a great extent, changed the perception of Chinese on air transport.

8.4.2 China’s strategy to build world-class state-owned-enterprises (SOE) including airlines

SOEs are one of the key features of China’s economic system. Over the years, the SOEs have remained to be the government’s favourite enterprises, despite a serious of cautious and explicitly experimental policy been implemented, resulting in dynamic structural changes of the SOEs. In the early days of China’s reform, the Government was very keen to empower the SOEs with greater autonomy so as to hold them accountable for their own financial performance. Incentives were provided and a proportion of profits were allowed to be retained. However, restructuring became a priority after 1992, which was designed to improve the poor performance of a significant number of SOEs. The Company Law passed in 1993 called for all business to strive for their wellbeing by taking measures to reengineer their financial structures, resulting in medium and big SOEs being listed on stock markets, while smaller SOEs

divested by lease or sale to individuals, and private enterprises encouraged to contribute to the national economic growth. The structure reform changed the ownership of majority of the industries, leaving up to 70 percent of those restructured firms being partially or fully privatized.

Despite the continuous reform, the central Government has never lost its control of the big SOEs, believing firmly that the state should control the key sectors of the national economy. Committed to forging a Socialist market economy, the Government argues that the development of strong and competitive SOEs is paramount and fundamental to retain the country's socialist characteristics and keep on track its economic reform. In 1997, the Party's 15th Plenary Session proposed that "the fundamental role of the state-owned economy should be reflected in its ability to control the national economic system. To this end, the state-owned economy should be restructured strategically so that the state holds an absolutely dominant share in the key industries and critical sectors which concern the livelihood of the national economy" (Ji, 2010). The Party further specified that the state-owned economy should include those natural monopoly companies and prominent businesses of high technology such as defence, electricity and grid, petroleum and gas, telecommunication, coal and mining, shipping and air transport in such industries as have a stake in the national security and provide essential public products and services. Such a philosophy underpinned the Government's move to create SASAC in April 2003 under the direct control of the SC, whose primary task being to reinforce the reform and restructuring of SOEs to ensure their capability to develop competitiveness internationally (Ji, 2010). In 1997, the 500 largest state-owned firms only held 37 percent of the state's industrial assets, contributing 46 percent of all tax revenues from the state sector (www.china-labour.org.hk). While in 2009, the 123 SOEs generated 12.6 trillion Chinese Yuan (\$1.93 trillion US Dollars) of revenues in sales, realizing 798 billion Chinese Yuan (\$115.7 billion US Dollar) profit (www.xinhuanet.com). Statistics showed that in 2009 the concentration of the core business of SOEs in major industries such as telecommunications and petroleum were respectively 96.4 percent and 93 percent while the concentration of the core business of SOEs in the airline industry was 88.3 percent (www.xinhuanet.com).

The Chinese airlines industry has always been considered as the critical industry to support the national economic growth with a big stake in the nation's security interest, with state ownership being the dominant theme. By deliberately classifying airlines into two categories, namely the Administration-affiliated and non-affiliated carriers, CAAC was able to give special and favourable treatment to its affiliated airlines through regulation. The Administration-affiliated carriers were the six carriers that were spun off from CAAC between 1987 and 1990, while the non-affiliated ones were the joint-ventures set up by municipal/provincial governments and local business such as Xiamen Airlines (1984), Shanghai Airlines (1985) and Shenzhen Airlines (1992). For example, in the late 1980s and early 1990s, CAAC would only allow 3 of its affiliated airlines to operate on international routes, with the rest being allowed to serve domestic trunk routes between Beijing, Shanghai and Guangzhou, as well as other major routes. For the non-affiliated carriers, CAAC would only allow them to provide domestic services connecting major airports from their home bases respectively or other feeder routes. Shanghai Airline was an exception in serving Shanghai and Beijing due to its intimate relationship with Jiang Zemin and Zhu Rongji, who used to be the City's Party Secretary and Mayor before taking the role of State Head and Premier. The non-affiliated airlines, such as Xiamen Airlines, did not receive its first international route licence for regional and peripheral operations until January 1996, 12 years after its initial launch (www.xiamenair.com.cn), while Shenzhen Airlines was only licensed on international routes in 2008, after almost 16 years of operations (www.shenzhenair.com). In controlling fleet planning, CAAC is able to allocate medium to long-haul wide-body aircraft to its affiliated airlines so as to support their trunk and international routes expansion, while leaving short-haul and feeder aircraft to the non-affiliated airlines.

As the reform intensified, CAAC encouraged its affiliated carriers to raise capital in both domestic and international stock markets, with China Southern and China Eastern being listed in the Shanghai, Hong Kong and New York markets in 1997, and Air China in the Shanghai, Hong Kong and London markets in December 2004. Air China made available 1.12 billion shares in the Hong Kong market, representing 40 percent of its total global offering of 2.8 billion shares. In contrast, when Hainan Airlines (1993) was listed in the domestic stock market in 1993, CAAC was not happy about its behavior

though failed to take any actions since the carrier was only a non-affiliated operator, over whom CAAC was only authorized to exert economic and safety regulation but not financial and human resource control (Le, 1997). When in 1994 the Government of Hainan Province sold 25 percent of its shares in Hainan Airline to an US investor without consulting with CAAC in advance, the Agency was really angered, denying that the foreign investment would be allowed in core aviation business (Le, 1997). In the end, the deal went through as an investment in the airline's CRS (Le, 1997). The airline had not received its first international route licence until February 2004, when it signed an agreement with Hungarian Airlines (Malev) to launch a Beijing-Budapest service no later than September the same year.

As more and more carriers have been authorized for international expansion, the central Government understands that stronger and more competitive national carriers should be nurtured to their full potential. The 3 megacarriers were thus brought under the big wing of SASAC in 2002 so that effective support and protection could be provided in the course of their growth whenever there is a need. SASAC was created as the watchdog of the central government (Kong, 2010), whose mission is to carry out the state's role as owner in the industrial economy. Although floatation is allowed of some of the companies in key industries in both domestic and international stock markets, the central government upholds the principle that state should maintain substantial control of those SOEs (Ernst and Naughton, 2008). Believing that the capability of maintaining a monopoly position in the market, it highlights the importance of focus on core business and financial returns and performance of the business rather than the economic growth, reform and fair competition (Ernst and Naughton, 2008).

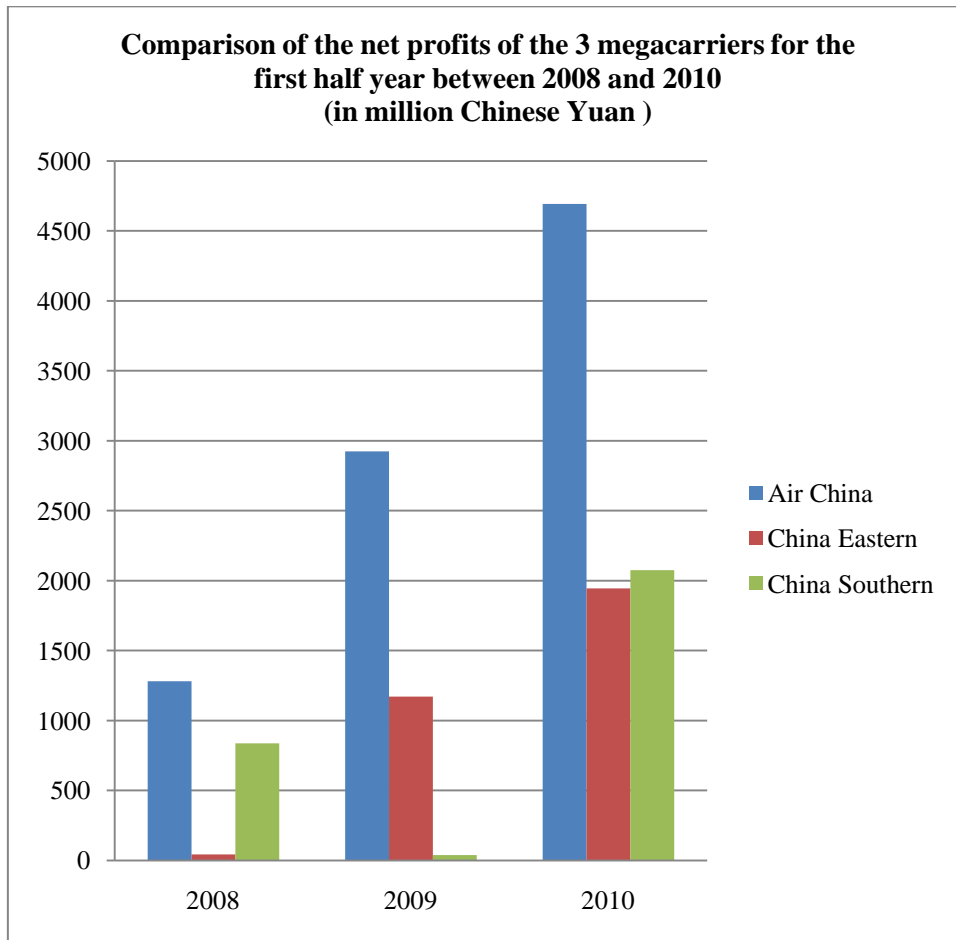
Managing the assets of 123²⁸ SOEs on behalf of the nation worth \$3.1 trillion (21 trillion Chinese Yuan), it is also responsible for recruiting and appointing the senior management positions of those SOEs. If required, SASAC would offer state aid to combat difficult times. Since December 2008, China Eastern has received \$1.3 billion

²⁸ There were 196 big SOEs under the control of SASAC in 2003 when the authority was first formulated with total assets of 7 trillion Chinese Yuan. In 2009, the number of SOEs decreased to 123 but the total assets increased to 21 trillion Chinese Yuan. 30 of them were among the world top 500 companies.

cash injection, while China Southern was granted \$411 million and Air China pocketed \$220 million, which is used to save them from bankruptcy, cut debts, and pay back their loans (Cantle, 2010). Believing that the coalition of strong plus strong would be stronger, in June 2009, SASAC brokered the merger between China Eastern and Shanghai Airlines, with an objective of optimizing resources in the Shanghai market so as to develop the city into a world-class multi-modal hub to compete with other cities in the region.

It is not surprising that the government-backed carriers lived well through the unprecedented financial crises. For the first half year of 2010, all 3 megacarriers reported a magnificent rise in operating revenues, with Air China recording 34.3 billion Chinese Yuan (\$5.04 billion US Dollar), an increase of 53 percent over 2009; China Eastern 33.6 billion Chinese Yuan (\$4.94 billion US Dollar) with a 92 percent increase; and China Southern 34.7 billion Chinese Yuan (\$5.10 US Dollar), a 39 percent increase over the previous year. Figure 8.10 compares the net profit of the 3 carriers for the first half year from 2008 to 2010.

Figure 8.10 Comparison of net profits of the 3 carriers for the first half year from 2008 to 2010.



Source: Xiao, 2010

8.4.3 Latest development: a harmonized society and economic development, China's new philosophy governing economic reform

In embarking its economic reform since 1978, China has faced the dual tasks of dismantling socialist institutions while constructing ones that promote a market-oriented approach towards growth (Tsai and Cook, 2005). By converging towards liberal trading practices, the country is able to liberalise its trade regime in a much shorter period of time compared with other nations in the region (Pekkanen and Tsai, 2005), recording a stunning economic growth to rank itself the second largest economy just behind the US. In this process, the government has played a decisive role in initiating policies to transform its centrally-controlled economy to a market economy.

While appreciating the success of its economic reform in improving people's life standards and enhancing the national comprehensive power, the government has also recognized some social problems accompanying its rapid economic growth. Issues such as uneven urban, rural and regional economic development, increasing pressures from human resource conditions, employment, wealth distribution, education, health care, housing, industrial safety, crime prevention and public and social security are prominent and evolving into a major threat to the country's social stability and further development, which has had a direct impact on people's life (Han, 2008). Concerns over social disparity and tensions have led to a major campaign spearheaded by the central government in 2005, which called for efforts of the entire nation to bring harmony to the society, the economic facet of which includes a better distribution of wealth to narrow the gap, increase in employment, increase in the funds for pension, unemployment benefits and health insurance, and the efforts to protect the environment. It also means advocacy of democracy, improvement of the democratic legal system and human rights protection, promotion of people's moral standards and securing public order (Li 2008). The rationale was that a sustained and coordinated economic growth could only be achieved where a social equity and justice system be established and maintained (People's Daily, 2005). It is regarded as a major policy change since the reform era began in 1978 which did not describe economic growth as the overriding goal of the country (Li, 2008).

To respond to the central Government's call, CAAC issued a "CAAC Policy Proposal with respect to the Party's Principles of the Sixth Plenary Session of Sixteenth Congress", articulating the strategic objectives for building a harmonious civil aviation industry to be achieved by 2020 (CAAC, 2007):

- The RPK should take more than 20 percent in the nation's overall transportation modes;
- The serious accident rate per one million flying hours should be less than 0.15 percent;
- Passenger satisfaction should be higher than 90 percent;
- Flight delays should be lower than 15 percent with delaying time being controlled within 0.5 hour against the scheduled departure time;

- Economic efficiency being improved and fair and orderly competition environment created;
- A coordinated development of air transport system between east and west, trunk and feeder routes, passenger and cargo operations, domestic and international, and regular public transport and general aviation .

CAAC reiterated that safety is a fundamental principle to be adhered to in the development of air transport. Overheated growth of air transport in major cities such as Beijing, Shanghai and Guangzhou should be refrained and subject to the requirements of the improvement of an efficient national route network. Liberalisation should only be pursued progressively, orderly and safeguarded with the objective of improving industry's overall competitiveness. As CAAC's Minister Li Jiaxiang pointing out that, "China's reform and its success relies on the appreciation of the circumstances of Chinese characteristics rather than the blind copy of foreign experiment. The key is to manage the relationship between the extent of reform, the pace of growth and the acceptable level of society. The fundamental principle to guide the future development of China's air transport industry will be to advance the reform while seeking societal stability and to reinforce this stability through reform" (Li, 2009).

8.4.4 Impact on China's international air transport policymaking

International air transport is regarded as an effective instrument to support the country's political and diplomatic objectives. China firmly believes air sovereignty is exclusive and non-invasive, thus international air links are a reflection of the diplomatic relationship between two countries. International trade should be facilitated to advance the country's political and strategic interests. CAAC, as an industry regulator is obliged to follow the central Government's policy direction in determining whether to establish air links, to open the market and to liberalise market so as to accomplish the nation's overall diplomatic and strategic objectives. Formulation of a liberalisation policy on a specific country-pair market is subject to the diplomatic conditions of the two countries, with technical issues such as market entry and capacity being determined by such considerations as whether the carriers are eligible for national treatment and protection.

For example, back in the 1950s, China only operated to those countries with which it had diplomatic ties, such as Russia and Pakistan. Since the 1970s, more international routes have been launched to Asian countries such as Japan and Thailand. The 1980's ASA with the US was a consequence of the establishment of diplomatic ties, while the non-ratification of Sino-Dutch ASA in the 1976 was the reaction of the Chinese Government to KLM's direct service to Taiwan, an act regarded as a violation of China's "One China" policy.

Before 1997 when Hong Kong was handed over to the Chinese Government, the negotiations between China and the UK with respect to bilateral air transport were more related to the whole package of arrangements. The China-UK market remained conservative and constrained until 2004 in terms of market entry and capacity compared with that between China and US, and China and the Netherlands, which reflected the sensitive and vulnerable political relationship between the two parties, with Hong Kong being a key issue.

In the 2000s, China's international air transport has been expanded to countries in Africa and South America, which is part of China's diplomatic strategies in the new era. In 2006, China held 28 bilateral negotiations, 6 of which were with African countries, 2 with Asian states and 2 with East Europe and Middle East countries. The first African route (Beijing-Dubai-Lagos) was launched by China Southern and the first South American route (Beijing-Madrid-Sao Paulo) was launched by Air China. In April 2008, an Additional Agreement to the China-Chile Free Trade Agreement on Service Trade was signed, which included aircraft maintenance services, sales and marketing of air transport services, CRS services, and airport ground handling and operation services, which is part of China's multi-polar diplomatic strategies that CAAC is required to give its support to.

8.4.5 Impact on bilateral negotiations between China and the US, the Netherlands and the UK

The central Government's overall economic policies have had a significant impact on CAAC's industry policy guidelines. For the Sino-US bilateral negotiations held in 2004 and 2007, as discussion in Chapter 6 reveals, CAAC proposed to the US that China

would welcome any direct links to be established between the US and Central, Western and Northeastern China so as to support the central Government's call for regeneration of these under-developed regions. To encourage the US carriers to fly directly into these regions, CAAC categorized all airports in the above regions into zones 2 and 3 and allowed unlimited capacity of operation. The offer was recorded in the 2004 and 2007 Sino-US Protocols. CAAC commented that the inclusion of zones 2 and 3 airports in the Sino-US protocols would significantly enhance the connectivity of the area and promote its economic growth. Likewise, the Netherlands is another beneficiary of CAAC's policy response to the central Government. In 2003's bilateral negotiations between the two countries, Chengdu, the capital city of Sichuan Province in Western China was agreed to be a destination in China for KLM to operate direct services, which became the first ever long-haul service connecting the city to Western Europe.

8.4.6 Influence of Interest groups

8.4.6.1 Influence of industry interest groups

Interest groups are generally involved both directly and indirectly in the process of policy-making. Though unlike in the US and the EU where consultation with stakeholders is a routine practice in the policymaking process, lobbying does exist in China, in spite that the methods of involvement and the approaches of influence are different, as a result of the different culture and political systems (Gao and Tian, 2006). Interest groups cooperate in lobbying for common interests but compete for individual benefits.

The industry's association, China's Air Transport Association (CATA), was only launched in 2006 by the trunk carriers including Air China Group, China Eastern Group, China Southern Group, Hainan Airline, Shanghai Airline, Xiamen Airline, Sichuan Airline, and an academic institution, China Civil Aviation University. Currently composed of 26 airlines and 23 aviation-related organizations, CATA invests most of its efforts in regulating the ticketing agencies by certifying their licences, processing their qualifications, monitoring their performance and implementing discipline against any misconduct. Though having participated twice in Sino-US bilateral discussions, evidence in the preceding chapters revealed that these

organisations were still in its early stage in representing its members to lobby the Government for the best interests of their industry members. This perhaps on the one hand is due to its shortage of competent staff, while on the other hand, is a reflection of the weak role played by industry associations, which, unlike those in the US and the EU, are the representatives of individual enterprises to voice the industry's concerns to the government (Kennedy, 2005), while China's business and trade associations do not have much autonomy, nor the sort of influence that the US associations have.

Contrary to the weak influence of the industry associations, the involvement of individual airlines in CAAC's policymaking has been historically long, close, direct and predominant with various effective approaches. One of the reasons is that commercial arrangements of international air transport operations between the two countries are negotiated at the Government level, a system started since 1946 when the US and UK concluded the Bermuda I bilateral ASA, with airlines and its national Government teaming up together to negotiate with their counterparts. In the case of China, the special relationship dated back to 1950s when China first established its airline industry. The airlines and CAAC used to be the same organization with two titles. CAAC's interest was aligned with that of airlines' while CAAC's voice represented precisely airlines' voice. Until 1987 when the economic reform in airline industry was kicked off, CAAC had acted both as a negotiator and an operator, representing the interest of both Chinese national Government as well as the commercial businesses.

In the 1990s China's economic reform still remained incomplete, with a mix of both planning and market forces operating in the economy. This left a great deal of ambiguity with respect to the definition of government's role and corporate responsibility, hence, the survival of firms was largely dependent on their relationship with Government institutions, which had the authority to control the financing and the distribution of key resources (Park and Luo, 2001). Organized on the basis of CAAC's six regional bureaus across China, with CAAC remaining the nominal owner of these airlines and controlling their operations and redistribution of the capital though it did not have any financial stakes, Chinese airlines had developed a special relationship with CAAC, which was anything but at arm's length (Le, 1997). CAAC not only controlled route licencing, capacity, schedules and pricing, but also fleet planning and financing. In

addition, CAAC controlled all the senior level personnel management by either appointing the managers or simply deploying its own officials to take the positions until 2004 when these powers were handed over to SASAC. At the same time, it was also a common practice for CAAC to recruit senior managers from the industry to take senior positions within its own institution. For example, the ex-Administrator Yang Yuanyuan was Chief Pilot of China Southern before being appointed Administrator in 2003. The current China Eastern Group's Chairman and CEO Liu Shaoyong used to be the Director General of the Flight Standard Department of CAAC before he moved to China Southern as its Chairman followed by the China Eastern position. The Party Secretary of China Eastern was previously the Deputy Administrator of CAAC in the early 2000s, to name just a few. Those in the middle-to-senior management positions who rotated their roles between the Agency and business were countless.

One phenomenon worth noting is that the intimate relationship only exists between CAAC and its affiliated firms that are state-owned and under its or SASAC's direct control. Since more than 90 percent of the industry has been dominated by SOEs, it has been these SOEs that are capable of managing the access to CAAC officials to get their voice heard.

The swap of positions and relocation of senior officials within the industry have enabled an intimate relationship to be developed, hence a special communication and networking channel being created. One of the advantages of such rotations is that these senior ranking officials or top management bring with them years of experience working in both public and private sectors, knowing every bit of airlines operations and bureaucratic procedures. They also have rich experience in dealing with various kinds of challenging issues in both domestic and international context, thus, allowing them to be equipped with the capability of addressing any issues that they might face in their positions. On the one hand, this type of personnel movement have certainly created a tremendous amount of fluidity and informal connections between airlines and its regulators, hence, offering airlines direct access to the top policymakers in the industry (Kong, 2010). CAAC is fully exposed to the influence of the industry interest groups, which will take every opportunity to get their opinion expressed and voices heard. The executives and senior managers could make phone calls any time they wanted or simply

come to visit CAAC at their own discretion. On the other hand, this kind of personnel arrangement among state-owned premier enterprises has also sent out a message to the industry: do not compete fiercely between each other, as what you are fighting with today might become your own child tomorrow. Competition is encouraged but not to the extent where one's success is brutally achieved at the cost of the other.

In addition, airlines' interest and considerations began to be divergent from that of CAAC, which had to consider not only the interest of airlines but the national interest at the diplomatic, military and strategic level. As CAAC still relies on airlines to provide information to justify its decisions, including the negotiation strategies and objectives to be achieved, its contacts with airlines have become more and more frequent. When feeding the information required, each airline would take the opportunity to express its views and suggestions on the prospective negotiations and policy choices, with an attempt of not only getting its own voice heard but also getting its request and demand considered and accepted. In this circumstance, CAAC had to attend to all arguments, either identical or competing, justify the rationale of their arguments and decide on the merits of each of the arguments for a balanced policy solution.

Since the late 1990s, individual airline have developed their own objectives with their interest beginning to diverge. Due to historical reasons, the state-owned airlines have been handicapped in terms of their capability of lobbying due to their specific areas of operation allocated under the regime of planned economy. For example, in the 1990s, Air China, China Eastern and China Southern lobbied more for international markets, while the other 3 carriers did not show much interest in international expansion. The restricted business scope and constrained operational capability such as fleet and base have undermined their willingness to lobby the government, and hindered their ability of lobbying, which in turn affected their enthusiasm in lobbying for their own benefits. Small, non-CAAC affiliated carriers such as Xiamen and Shenzhen Airlines did not launch any lobbying due largely to their no presence in the selected three country-pair markets. Cargo carriers only started their lobby campaign in 2000s as a result of their intention to develop international freight operations.

When lobbying, while there were occasions when those who voiced the identical stance asking for protection from the competition of external international airlines, there were also instances when they had conflict of interest with each other battling for the same benefits, for example, an international route licence and capacity, or objecting the rest from entering the lucrative and profitable country-pair and city-pair markets.

These differences were best demonstrated before each round of discussion between China and the US since 1995, between China and the UK since 1997 and between China and the Netherlands since 2003 when CAAC took sound from airlines and airports. As empirical findings in Chapter 6 and 7 reveal, when some airlines were keen to enter a bilateral market, others were strongly against any new entrants, fearing that they would face more competition. When the foreign counterparts demanded more access to market entry rights and capacity entitlement, the Chinese carriers were united in voicing against their foreign rivals. For example, Great Wall Airline, Jade Cargo International, Shanghai Cargo Airlines and Hainan Airlines all applied to CAAC in 2003 and 2004 for Sino-US route licences, giving the reason that they were responding to the Government's call to promote cargo traffic and enhance international trade, as they were able to take advantage of their respective bases in Shanghai and Shenzhen where the majority of China's export products were manufactured. In contrast, the incumbents such as Air China, China Eastern, China Southern and China Cargo, were not enthusiastic about relaxation of market entry restrictions, being fully aware of their current financial situations and the fierce competition encountered with their aggressive international rivals. None of them were in favour of the increase of designation and frequencies, free commercial arrangements and establishment of cargo hubs. They argued that there were still traffic rights available between the two countries which needed to be exploited and that the US's strict visa procedures for Chinese citizens prevented them from operating as efficiently as their US counterparts.

Contrary to the airlines community, Chinese airports have only become proactive in lobbying the Government since the 21st century with respect to establishing international links. This is understandable in that 1). Chinese airports were under the control of CAAC before 2004 which had no autonomy of its network development; 2). Chinese airports were not managed as enterprises but as a quasi-public service

organization with no entrepreneurship. After the airport reform completed in 2004 when all airports except BCIA and those in Tibet were handed over to local governments, airports have been extremely enthusiastic about establishing international links, not only in terms of infrastructure but as a service provider to support the local economic growth. The best showcase was Hangzhou airport, which successfully lobbied the provincial Government of Zhejiang, which in turn supported its proposal and together the two lobbied CAAC for a direct link between Hangzhou and Amsterdam. The city was included in the route schedule in 2010's negotiation between China and the Netherlands, leading KLM to launch a service last April.

8.4.6.2 Impact on the specific market-pair policies

Chinese airlines derived their existence out of the Government institutions. Their interest used to be the same as that of the government, though gradually they have departed to their own way. Like any other business operating in the commercial environment, airlines are not only service providers but also social organizations that require a stable environment in order to survive and prosper. Their concern about the profitability would either drive them to seek for an assured closed market to receive benefit from protectionist measures or fight for treatments for expanding into new markets. Therefore, airlines have the choice of either supporting the government's policy when they perceive that the policy will be conducive to their own commercial objectives, or opposing the policy when they believe that the policy is not doing any favour to their operations.

When being owned by the government, an airline shares the identical national interest as the government. In the 1980s, when CAAC and Chinese airlines were simply one entity with two names, the government's view was the airlines' view. They shared the same objectives. There was no need to lobby the government. When it came to the 1990s when airlines were separated from the industry regulator, their mindset began to be divergent and they developed different perspectives and approaches towards policy issues. Airlines wanted to have more protection from the Government when they perceived a threat from external competitors, while at the same time, they competed for their own interest when they had their own benefits and interest to protect. This was

evidenced by the different views and opinions of different airlines in dealing with the Sino-US, UK and Netherlands markets respectively. When they perceived good opportunities in the market, they would lobby the Government to relax the restrictions, as was the case with the China-Netherlands arrangements in 2003, when China Southern wanted more capacity and codeshare arrangements. For the 1999 Sino-US arrangements, almost all airlines shared the same view that they were not well prepared for the capacity increase, though the negotiation results did not reflect the airlines opposition and concerns.

For the 2004 Sino-US discussions, as airlines were divergent in their views towards market entry, the negotiation result was able to satisfy part of the requirements of some of the Chinese airlines, while upsetting others, especially the incumbents. However, this did not indicate that the new entrants were more influential in affecting the government's policymaking process. It rather demonstrated that the industry regulator was first of all responding to the central Government's call to remove the barriers to market entry to keep its commitment to the WTO. With this in mind, the Government satisfied some airlines' requests because these requests were the response of business to the central Government's national strategic call. By being unable to satisfy other airlines' requirements, the industry regulator was not denying their requests, but encouraging them to react proactively to market forces and push them to be pro-competitive.

8.4.6.3 Local government as an interest group and its influence

The local government in China usually refers to the provincial government and the 4 municipal governments in Tianjin, Beijing, Shanghai and Chongqing, which manage the administrative regions on behalf of the SC. China's economic reform started in 1978 decentralised its economic planning system, enabling local governments to formulate their own socio-economic development strategies that best suited their local circumstances.

Despite the central Government holding a superior power over local government constitutionally and controlling the national economic policy at the macro-level, it does not mean that local government is passive in accepting the instructions. On the contrary,

local government can exert significant influence on central government for a preferential policy, especially in the areas of foreign investment and international trade, so as to ensure that it is empowered to achieve its economic goals. The interest of local government is two dimensional (Hampton, 2006). Economically, local government takes sole accountability for stimulating local economic development, such as creating jobs and generating tax revenues to safeguard the wellbeing of the local residents. Politically, it means that the performance of the local government officials is measured against their achievements in promoting local economic growth, which directly relates to their career development. Thus, local government is so motivated and committed to their economic achievements that it would do whatever it can to achieve its goals.

When the SEZs were established in the 1980s in those cities along the east and south coastline, flexible policies and incentives were given which were believed to be attractive to foreign investors in order to stimulate local economic growth. Soon afterwards, the local governments recognised that the preferential policies were not sufficient in attracting foreign investment due to the lack of effective and convenient transportation and telecommunication systems in cities such as Xiamen, Beihai, Zhuhai and Fuzhou where the landscape is more complicated for railways, which used to be the most popular and main transport mode in China. To overcome this obstacle, local governments as exemplified by Xiamen were convinced that air links were essential for developing its economy. Thus, improving infrastructure and the transport system became a primary task, resulting in the local governments being inspired to finance their own airport and set up their own airline. These coastal provinces with a heavy proportion of foreign trade and a high trade dependence ratio not only have a stake in the direction of Chinese economic policy, but also have access to internal channels to exert influence on the policymaking process (Chen, 2008).

To resolve the air transport issue, the local governments had to lobby CAAC, which is the sole government authority to administer air transport activities including the construction of airports, procurement of aircraft and licencing and allocation of routes. Consequently, CAAC becomes the target of the local governments which are so determined to develop their air transport markets. They either visit CAAC directly or write or telephone CAAC to put forward their specific requests. Before the 1990s, the

lobbying from local government had mainly focused on airport construction and airlines setup, due to the fact that the local governments were keen to support its economic growth and CAAC could not allocate sufficient budget for such construction. For example, Xiamen Airport was approved for construction in 1982 jointly financed by CAAC and the local government. Following that, Xiamen Airlines was agreed to be set up in 1985 funded by CAAC and the local government. Shanghai Airline was set up in 1986 and Putong airport was constructed in 1998. Shenzhen Airport started being constructed in 1990 and the Airline was set up in 1993.

When it comes to the 21st century, the lobbying changed its theme by asking for more traffic rights for direct international links. The airport localisation programme which started in 2002 and was completed in 2004 transferred the ownership and control of all airports (except Beijing and Tibet) to the local respective governments (www.caac.gov.cn), resulting in the significant enthusiasm of local governments to promote international air links. Senior officials including governors would lead teams personally to meet CAAC Administrators on various occasions whenever possible to present the business cases in an attempt to convince CAAC that their respective province should have a direct international link. Provincial officials at junior levels would work directly on relevant departments of CAAC. It is reported that since 2003, CAAC has signed tens of MOUs with local governments, including Hainan, Jiangsu, Zhejiang, Fujian, Heilongjiang, Jiangxi and Henan (www.caac.gov.cn), pledging to give them full support in their pursuit for international services by both Chinese and international carriers. The lobbying proved to be successful in many ways as almost all the major airports in these provinces were included in the agreements concluded between China and the US in 2004 and 2007 Protocols, as well as between China and the Netherlands in 2006 and 2010 MOUs .

A best showcase is Hainan. Hainan became a province in 1988 being permitted special policies to speed up its economic growth. As an island, Hainan relies heavily on air transport for external communication. Without much manufacturing or agriculture, the travel industry is the key to Hainan's development and establishing international links became the top priority for the local government. The idea of opening more international routes was initiated by Hainan Airlines in late 2002 and early 2003, which

after 10 years of operation, found itself in a desperate need to expand into a bigger domestic and international market. The suggestion gained immediate support from the then Party Secretary of the Province Mr. WANG Qishan, currently a Vice Premier. “A proposal to have Hainan Province open for third, fourth and fifth traffic rights on a pilot basis” was submitted to CAAC in February 2003 and was approved the following month.

To implement the strategy, a special “Flight Management Office” was set up and very generous incentives were made available with the aim of attracting international operations, which included operational tax refunds for the first three years of operations commencing in January 2004 and favourable tax arrangements for warehousing, logistics and terminal operations. The local government would also provide 10 million Chinese Yuan (\$1.40 million US Dollar) per annum to subsidize any airlines flying to or via Hainan should their operations be loss-making (www.tax.hainan.gov.cn). In June 2004, Hainan as a special zone in China was documented in 2004’s Sino-US Protocol, allowing operations of carriers from both countries with full 3rd, 4th and 5th freedom traffic rights.

To sum up, local governments in China have played a critical part in China’s international trade policymaking since 1978. Although China as a unitary administrative system with central Government taking the dominant role in governing the country, local governments have enjoyed to a great extent autonomous authority in developing their own economic objectives, strategies and initiating their own trade programmes. Unlike other industries such as textiles, agriculture and automobiles in which the local governments have the authority to determine their operations, international air transport is centrally controlled by CAAC, which is independently managed at the national level and is free from any official involvement in its policymaking process from local governments. As a consequence, there are no formal institutions or mechanism for local government to make their voices heard (Feng, 2006). In this circumstance, the influence from local governments can only be exercised when the local governments approach CAAC directly, either in person or via other methods such as lodging a report. Local governments are able to take advantage of the policy of the central Government to press CAAC for a preferential international air transport policy. When they have technical

support from specific airports within their jurisdiction, their strategy of joint lobbying tends to work effectively. In the 1980s and 1990s, they teamed up for the construction of airports, while in the 21st century, they collaborate to argue for direct international links. In terms of the Sino-US, Netherlands and UK markets, the preceding analysis has revealed that local governments are capable of manipulating the situation to win approval from CAAC with their cities/destinations being included in the bilateral agreements, regardless of the effect of implementation. From this perspective, local governments in China have had played a bigger role in influencing CAAC's policy making process though their chances of success is subject to other factors such as the availability of other policies available to support the initiative, their channels and effectiveness of communication, the support of their local aviation industries and their capabilities of presenting the business case.

8.4.7 Role of media and public opinions and their impact

The media that reflects public opinions has a strong impact on government trade policies and international negotiations (Swinnen and McCluskey, 2006). As mass media becomes the key information broker in our society (Swinnen and McCluskey, 2006), where most people obtain information and express their opinions, it can affect the political agenda by influencing policymakers' perceptions and attitudes, and create the "climate of opinion" by determining what issues they consider important and how they think about these issues.

However, the ability of the media to influence trade policy was circumscribed by three conditions, as Dennis Harter when being interviewed by O'Heffernan (1991) pointed out, namely:

- a) Media influence varies with the nature of the issue, with global, multilateral issues being more sceptical to media influence than bilateral or military issues;
- b) Media influence derives to some extent from the media's ability to stimulate domestic political forces to support or object to a policy initiative;
- c) Media influence varies with the prevailing political environment, although it can influence or create that environment.

Studies by Yu (2005) about the role of Chinese media in influencing the formation of China's policy towards the US and the US-led war in Iraq revealed that the different contents covered in different media had a significant impact on the opinions formed by the Chinese public, though had not necessarily changed China's policy output. As mounting numbers of Chinese are gaining access to not only the domestic media but also global media via the internet (Lampton, 2001), Chinese policy makers are beginning to attend to the public opinions expressed and sensitive to the views presented in both domestic and international media.

There are only a few industry journals covering air transport, which include "China Civil Aviation", a monthly magazine controlled by a publishing house affiliated to CAAC, carrying professional and technical articles with analysis and comments, and "International Air Transport", a monthly magazine published by the CAAC Management Institute which is also affiliated to CAAC, carrying mainly translated articles from international news sources. The only industry newspaper is the "CAAC Journal" controlled and published by CAAC four times a week with updated news, reports, analysis and comments on the industry. As the official voice of the Agency, it usually is the first to disseminate policies, reports, speeches and remarks that CAAC would like to get known. Other mainstream media such as People's Daily and China Daily (China's sole official English newspaper) do not cover information regarding air transport on a daily basis but do carry stories that they believe bear significance such as aircraft ordering, air accidents, big airport construction projects, airline mergers and acquisitions, and traffic growth in China and the world. Some local and financially focused newspapers also carry news and analysis about air transport but are totally subject to their own choice as to what to write about. For example, "Caijing" (Finance and Economy), a monthly journal in Chinese, analysed the prospect of low cost carriers in China in 2005 and airline mergers in 2006 (www.caijing.com.cn).

The most popular website specializing in air transport was set up by a private internet company www.carnoc.com based in Hefei, Anhui Province. Initially launched in October 1999, it gathers all the real-time news and reports from all news source available and is regarded as a comprehensive source of information with an average number of visits exceeding 4.1 million based on the statistics provided by Google

Analytics in September 2008 (www.carnoc.com). Without any official or bureaucratic background, the website carries critical and objective analysis and comments that are not found on other official media, especially with respect to a particular policy issue or an event such as new route licence procedures, low cost carriers in China, flight delays, air fare competition, as well as China's "Open Skies" policies. When the 2004 Sino-US Protocol was concluded, the website was loaded with articles either written by its own reporters or from other media that complained that the Chinese Government was too fast in opening the China-US market, where the Chinese carriers, who were not prepared at all at this stage, had to face the biggest challenge from the most competitive airlines of the world; and that the Chinese Government did not listen to what the domestic carriers said, nor protected them effectively (www.carnoc.com). However, further examination of the database on the web has revealed that there was not little coverage with respect to China's negotiation with the US in 2007, no coverage on China's consultation with the Netherlands over the years, nor coverage on the country's arrangements with the UK over the years.

International industry magazines such as Orient Aviation, Payload, Air Transport World and Airline Business, to some extent, do cover news reports about China, though not necessarily on a regularly basis. International newspapers that often carry news and comments with respect to China's air transport industry include "Asian Time" and "the Strait Times" based in Singapore, and "the South Morning Post" based in Hong Kong. A quick search of the archives reveals that their more often coverage about China only started since 2000. They tend to selectively focus on a specific event or an issue with their analysis and comments from an international perspective. However, the above media, due to its conveyance medium being the English language, does not carry as much weight as those in the Chinese language, the mother tongue to China, nor is it considered of the same significance as the Chinese media which is believed to reflect the opinions of Chinese citizens. Nevertheless, this does not mean that the views reflected in this type of media are not attended, received, or appreciated. On the contrary, when a completely opposite view is expressed from what is heard from the domestic media, Chinese policy-makers will pay special attention and keep on monitoring the messages. For example, media clippings especially from English newspapers such as "the Strait Times" and "Wall Street Journal" were collected by

CAAC after the conclusion of the 2004 agreement in order to learn international reaction which was used for reference for future discussions.

Notwithstanding a handful of industry papers and journals in both Chinese and English that are available and do carry some information about China's air transport industry, it is still not common for one to locate any news release or reports with respect to China's international air transport policy issues. Bilateral negotiations and their results with the relevant country are not much covered either. Nor is such information found in those mainstream media such as People's Daily and China Daily. One of the reasons is that China still holds that any news relating to international affairs and bilateral relations are classified information which should not be released to the public, with CAAC following this practice. Another reason is that international air transport policy is not an issue that the media can create an image that tends to persist with the general public who will be intrigued to voice their opinions or participate in a hot debate that will increase the readership. International air transport policy is something up in the air that is intangible for the Chinese public, who are more concerned about flight safety and service quality, such as flight punctuality and meals onboard.

In summary, although China is becoming a tourist source country, those who can afford international travel are still a small proportion compared with its population. In terms of China's international air transport relationships with other countries, except for industry professionals who appreciate the economics of airline/airport operations, ordinary people do not yet recognize the benefits of liberalized arrangements. For them a cheaper ticket from whichever airline is sufficient as long as they are taken to their overseas destination. For many Chinese who travel to the US, Europe and beyond, they actually find foreign carriers more convenient who can arrange their transit or transfer connections outside China with their widely-reached networks. As a consequence, the low levels of media attention on international air transport policy issues fail to attract the attention of policy makers, who, in turn, would not amend their policy agenda or revise their policy direction or priority. The media itself has not recognized the significance of international air transport policy and its impact on the nation, the people and society as a whole, hence is not convinced of the value of carrying international air transport policy-related issues to be released to the public. For the research of the three

country-pair markets, media and public opinion apparently has not carried much weight in influencing the policy agenda nor considerations of the policy formulation. Although media coverage caused some special attention from policymakers after the 2004 Protocol between China and the US, it has not been influential to the extent of exerting pressure on policy makers for a policy adjustment or policy change or crafting their mindset or shaping their views towards the subject matter. Therefore, it can be concluded that the role of the media and public opinion is limited in terms of influencing China's international air transport policymaking process and influencing specifically China's strategy on the three country-pair markets.

8.5 Factors at the institutional level and their impact on policymaking

Scholars such as Krasner (1984) and Bailey et al. (1997) conceived that institutions have direct or indirect impact on a nation's political process over time. Government institutions are not merely executive organs implementing the orders received from its superiors but rather play critical roles in the policymaking process which could either facilitate or distort the policy objectives. They argued that institutional changes, for example, could influence the dynamics within a nation's bureaucratic apparatus, which would ultimately have an impact on the agency's agenda. Such changes would in turn affect the bureaucrats in their delivery of the policy outcome and their capabilities in achieving the policy objectives.

Although China's bureaucratic structure is different from that of other western democratic countries, its regime and system has empowered its institutions and bureaucrats a far more authority in manipulating the policymaking process, thus exerting a larger impact on the policy output. The following part of the chapter turns to the institutions involved in China's international air transport policymaking and seeks to analyse how these institutions concerned in the process relate to and interact with each other leading to a policy outcome per se.

8.5.1 China's aviation policy-making authorities

As a socialist country, state socialism is a politically monopolised system in which all power is focused at the top and lower levels are subordinated and dependent, deriving

power as it is distributed from a higher level within the hierarchy (Huang, 2002). Dominated by a single party, the Chinese Communist Party, formally organised on Marxist principles, its authoritarian or totalitarian features resulted in stress due to the alleged firm grasp of the state over society, the absence of the rule of law, and the hierarchical structure of power (Huang, 2002). Neither society nor the economy retains independence from the control of the Party, which has the overarching authority above the other layers of the bureaucracy. The most powerful policy-guiding unit within the CCP is the Political Bureau (Poliburo), and within the Poliburo, its Standing Committee.

As the world's largest developing country, though China has recently been recognised by the western world for its market economy status, the central Government still plays a key role in intervening in economic activities by exercising autonomy from the top level down. The SC is the highest executive organisation of state power and state administration. Being charged with responsibility for developing policies and the implementation of laws and regulations, the SC is concerned with China's international relations as well as domestic policies, economic, financial, educational and cultural issues. Headed by the Premier, who, along with 4 vice premiers and 5 state councillors, each of whom has a specialised area of responsibilities with industries such as air transport and telecommunications, the SC administers China's bureaucracy, including all ministries, special commissions, bureaus and administrations affiliated to the ministries.

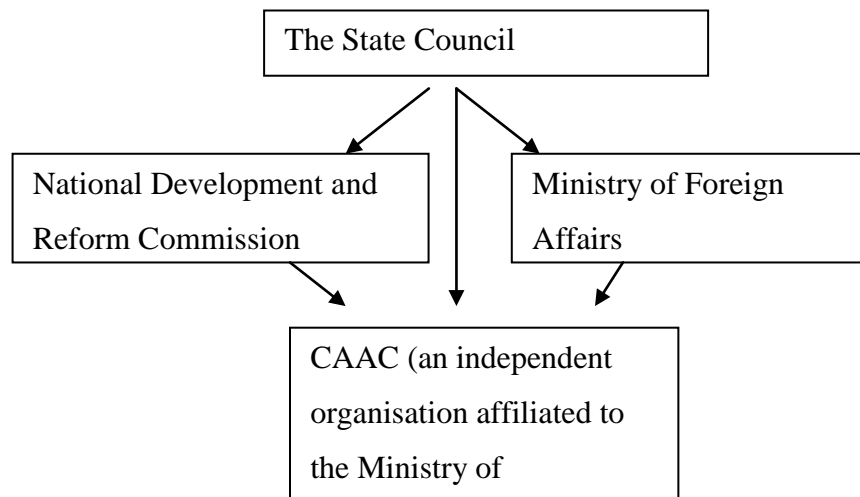
With respect to international air transport policy-making, the following organisations are involved though to a different extent: National Development and Reform Commission (NDRC), MFA and CAAC (Figure 8.11). NDRC oversees China's overall economic policymaking from both macro and micro perspectives. The annual and five-year strategic plans for the national economy and social development spell out the goals and objectives to be achieved for industries, including air transport. The Commission also monitors the implementation of the above strategic plans.

MFA is charged by the SC to be responsible for China's overall policy concerning foreign affairs, in particular, developing and implementing the country's diplomatic

policies in the international arena, though technically it reports directly to the Standing Committee of the Poliburo (Lu, 1997). The Policy Planning Department provides advice on China's international economic and financial policy based on their analysis and assessment of situations worldwide, while the Department of Treaty and Law is involved in bilateral air services negotiations, giving full support to CAAC regarding legal issues with respect to bilateral agreements. Other departments overseeing a particular region such as the Department of North American and Oceania, the Department of Western Europe might be consulted internally for policy advice when a specific discussion is concerned with a specific country.

Unlike other bureaucratic agencies which need to seek consensus with other bodies concerned before a certain policy is formulated or implemented, in terms of international air transport, CAAC bears the sole responsibility for developing the policy directions and negotiating with its counterparts for a policy output. The Department of Policy and Law is mainly responsible for policy research and formulation while the Department of International Affairs and Cooperation is charged specifically with the duty to formulate international air transport policy and conduct bilateral air services negotiations on behalf of the Chinese government. Other government authorities such as the MoC and the CNTA are consulted respectively for updated information in terms of international trade and travel as well as for specific suggestions and advice with respect to international air transport prior to each round of bilateral negotiation, so as to ensure that the principles governing the negotiations are adhered to, the bottom line is upheld, the national and public interest is considered, reflected and protected, and the negotiation outcome corresponds with and reflects the nation's overall diplomatic and strategic objectives.

Figure 8.11 Relationship between Chinese bureaucracies with respect to international air transport.



Source: Compiled by the author

8.5.2 Structural changes

In parallel with its economic reform, China's political reform also follows an evolutionary path, which saw the downsizing and streamlining of China's bureaucracies over the last three decades. Corresponding to the national administrative reform, CAAC experienced several structural changes seeing itself separated from the Air Force in the early 1980s to being merged with the MoT in 2008. Despite various structural changes over the years, the core responsibilities of CAAC, namely regulating the domestic and international air transport operations from economic and safety perspectives remain unchanged.

Historically, CAAC was part of China's Air Force but being charged with the responsibility for overseeing non-military air transport activities. As a quasi-military administrative agency, CAAC received instructions from the Air Force in terms of its human resource management and air traffic management, though it was authorised to regulate, while at the same time, carry out all civilian and commercial air transport

operations in both domestic and international markets. It acted as an industry regulator as well as a corporate business.

8.5.2 1. First structural change in the 1980s

The first structural change came in 1980 when Deng Xiaoping called for civil aviation to be corporatized, resulting in the separation of CAAC from the Air Force while retaining its obligation to report to the SC with respect to its management as a sub-ministry level agency. The intention was to help CAAC to establish a concept of modern management of the airlines industry in order to demolish the monopoly control on the industry. This was not an easy task due to the fact that CAAC had been traditionally overshadowed by the military such that it required Deng Xiaoping's personal efforts and intervention to be successfully accomplished (Williams, 2009).

The launch of the 6 major airlines²⁹ had not been achieved until 1988, almost 8 years after Deng's call to reform the civil aviation sector. CAAC retained its authority over market entry, capacity and pricing on both domestic and international operations. It also determined the fleet size and investment for airport and air traffic management facilities. In terms of international air transport, it remained the negotiator of bilateral air services agreements and oversaw the implementation of the arrangements but divested operational control to those recently-established carriers. For the Sino-US and UK markets CAAC was replaced by Air China in 1987, with China Eastern becoming the second designated carriers on the markets, as previously discussed.

8.5.2.1 Structural changes in 1993

In 1993 a radical change in terms of CAAC's bureaucratic status occurred in that it was upgraded to a ministry-level agency under the direct control of the SC. The justification was that the rapid growth of the industry over the past decade caused severe safety

²⁹ The 6 major airlines were: Air China established in Beijing in July 1988, China Eastern in Shanghai in June 1988, China Northwest in Xi'an in December 1989, China Northeast in Shenyang in June 1990, China Southwest in Chengdu in December 1987, and China Southern in Guangzhou in February 1991.

concerns³⁰, which alarmed the central Government to take proactive actions to refrain the over-enthusiasm towards air transport from the local provincial governments, which were so keen to have airports and air services in place to attract foreign direct investment. One of the measures taken was to strengthen the position of CAAC within the national bureaucratic system to bring it into the mainstream of the agencies of the SC and appoint the then Party Secretary of Fujian Province Chen Guangyi (December 1993 to June 1998) as the Administrator. The move was intended to empower CAAC with an exclusive authority over the industry. Without much modification of its duties, it was intended that CAAC could be better positioned in the national bureaucratic system to exert its power to regulate the industry.

The early years of Chen's tenure failed to cool down the overheating towards air transport in the nation. In 1995, there were 43 airlines operating in China, most of which were established by the local provincial and municipal governments, with some smaller ones operating with only 2 to 3 Russian-made airplanes. Price wars started with airlines selling tickets at less than 50 percent of the published fares, leading the CAAC together with the National Planning Commission (NPC) responsible for the price reform of all industries in China to promulgate a series of regulations in an attempt to control air fares. The 3 big carriers –Air China, China Eastern, and China Southern at the same time consolidated their market power carrying 56 percent of the total paying traffic in 1997, and providing 79 percent of the domestic services.

8.5.2.2 Dramatic downsizing in 1998

Failing to regulate the industry effectively, CAAC was further challenged by another round of administrative reform in 1998, when the agency was required by the SC to halve its size, cutting its staff numbers from 450 to 252 without jeopardising its responsibilities. For the first time in CAAC's history, the bureaucrats, a good percentage of whom were ex-military officers after years of civil service in the government agencies, were concerned about their personal career prospects, panicking

³⁰ Between July 1992 and December 1993, nine aircraft crashed as a result of industry expansion causing a serious shortage of professionally qualified and experienced pilots.

with a desperate desire to know where they would go to work the following day. The functional departments, being involved in the economic regulation of both domestic and international operations, were unable to retain all of their veteran staff due to the quota requirements. To cope with the workload, CAAC had to make casual arrangements with airlines and other CAAC-affiliated organizations, which were able to provide temporary human resources without affecting the employment relationship. The reform was not completed until 2002, when CAAC was deprived of some of its major responsibilities. For example, SASAC rather than CAAC would be in charge of the carriers' financial and operational performance and the appointment of top management of the 3 big carriers that were forged out of the previous 6 trunk airlines. CAAC was also deprived of the responsibilities of managing all national airports financially and operationally (except Beijing Airport and those in Tibet). The Agency also accommodated two ministers during this period of time, with Liu Jianfeng serving from June 1998 to May 2002 and Yang Yuanyuan succeeding Liu till December 2007.

From 1998 till 2007, China's air transport industry experienced a radical structural change with the most significant taking place after 2003 during Yang's tenure. With a pilot background, Yang was considered very open and fully embraced the trend of international air transport, in contrast to his predecessors Chen and Liu. He was well received in the international aviation community being nicknamed as triple Y, attributed to his effective communication skills and straightforward personal style and was referred to by IATA's CEO as "he was the one" (IATA, 2005).

During Yang's period, cargo operation was proactively advocated and promoted by CAAC to support the country's export-oriented economic growth. Domestic private capital was also allowed into the airline industry, bringing about several start-ups which adapted the LCC business model. Industry consolidation resulted in 3 megacarriers dominating China's domestic and international operations with an aggregate 80 percent market share (Williams, 2009). By joining international alliances including Star Alliance and SkyTeam, the 3 trunk airlines were ambitious in developing organizational capabilities to compete on a global scale.

8.5.2.3 The latest move to bring CAAC under the MoT

In 2008, the SC decided to further advance its political reform by announcing to integrate CAAC into the MoT, while at the same time downgrading its status to a sub-ministry level, despite its responsibilities being unaltered. The intention was to streamline the regulatory functions of some of the government departments whose responsibilities overlap and/or conflict with each other. The new MoT would be charged with the tasks of overseeing road, water, air and postal services, being composed of functions previously undertaken by the Ministry of Communications, Ministry of Construction, CAAC and State Postal Bureau. Administrator Li Jiaxiang was also appointed Vice Minister of the MoT with specific responsibilities for overseeing air transport activities. With a military background, Li was first involved in civilian air transport in November 2000 when he was appointed Party Secretary of Air China Co Ltd. In two years' time, Li was promoted to Party Secretary and Vice President of Air China Group, one of the three mega-carriers which took over Southwest and Zhejiang Airlines. In December 2007, Li replaced Yang Yuanyuan to become the 12th Administrator of CAAC (www.caac.gov.cn). Believing that competitiveness of Chinese airlines will only be gained and developed out of further industry consolidation through merger and acquisition, he advocates cooperation, integration and alliance among carriers to achieve the government's goal of having two or three large Chinese carriers with international competitiveness (www.caac.gov.cn).

Despite retaining a significant degree of autonomy within the mechanism, CAAC now needs to report to the MoT rather than directly to the SC with respect to domestic and international regulatory issues, which has created complexion in terms of procedures to follow and longer lead time before any reply or instructions are received. This is due to the political culture that in China bureaucratic ranks are so important that negotiations and coordination can only be performed among bureaucracies at the equal level with those in senior ranking having the authority and power to give instructions and orders to the junior (Kong, 2010). Remaining on its previous premises, it is anticipated that the relationship between the MoT and CAAC would replicate to some extent the management system of the US to be found in the DoT and FAA (Williams, 2009). Operating in the new framework while trying to integrate itself into the new

organization, CAAC was not assured of its future status, with speculation that the Ministry of Railway and the current MoT will eventually merge into one super-agency looking after all modes of transport for a better coordination and planning of the system. With this down the line, it is hoped that a concerted culture can be developed so as to support the organizational change without affecting the performance of the staff.

8.5.3 Impact of structural changes on the country's international air transport policymaking

Bureaucracies are created by governments to implement policy. However, they adversely have a role to play in the process of policy making which can not be entirely separated from policy implementation. Organisational theories have argued that bureaucratic culture, once established, are difficult to change even when underlying social forces continue to evolve, as particular institutional arrangements create privileged positions for individuals and groups who work to perpetuate those arrangements (Ikenberry, 1988). Individuals within the organizations would seek to preserve and protect their missions and responsibilities even when the specific circumstances that brought the organization into existence have changed (Ikenberry, 1988). The cost and uncertainty involved in the organization change usually generate countervailing incentives for the maintenance of the existing organizations (Ikenberry, 1988). Bureaucracies with their featured culture, rituals and routine responsibilities have a direct impact on the way the individuals involved perceive interest and value, both domestic and international (Ikenberry, 1988). Such organizational characteristics can bias the way in which the imperatives of an international system are perceived and acted upon, hence, influencing the capabilities of officials to diagnose the environment to formulate the policy (Ikenberry, 1988). Bureaucratic organizations with their own power and resources could stir up the policy process by shaping the perceptions of political actors, thus affecting the policy outcome.

Unlike other ministries or governmental agencies which have been abolished, reshuffled, merged, created or restructured, with their functions and roles being deprived, altered and adjusted through rounds of administrative reforms, CAAC has been able to keep hold of its core duties and responsibilities as an economic and safety

regulator despite of seeing itself upgraded and downgraded with the number of employees being increased and decreased. The constant but not consistent restructuring has enabled the agency to spin off its non-governmental obligations to focus on the development of its regulatory capabilities but at the same time dramatically weakened its administrative, human resource and financial capacity to govern the air transport sector. It is no longer the authority to dictate management and operational issues of the industry; no longer to appoint/relocate/second top level management to airlines and airports; no longer to collect the proportion of operational profit of the industry. The deprivation of these authorities has had a side-effect on the competencies and negotiation capabilities of the institution, the motivation, incentives, morality and performance of the senior officials as well as staff as well as inconsistency of policies, procedures and implementation strategies. For example, the administrator, chief negotiator and supporting officials changed consistently. A remarkable number of veteran staff was lost resulting in whom being replaced with green hands, who need time to gain administrative and negotiation experience. Though it is hard to justify how this has affected the negotiation outcome, it is widely accepted that more experienced negotiators and supporting assistants are more capable to manipulate the situation to get a better deal for one's benefit.

Nevertheless, CAAC is able to retain some of the key officials who have extensive industry and international experience and engage them in taking a leading role in the process of policy making, negotiating bilateral arrangements and overseeing the implementation. In addition, as the system allows CAAC to commission retired veterans to conduct research on a particular subject matter and arranging in place temporary staff from the industry to offset the workload, CAAC has managed the manpower shortage to a certain extent to ensure its capabilities in delivering policy although this does not mean that CAAC has maintained its high level of expertise in bilateral negotiations with the countries selected for this research.

CAAC developed its regulatory functions out of a quasi-military background. From acting as an operator in the 1980s to protecting the operators in the 1990s and to learning to regulate the operators effectively in the 21st century, CAAC has been actively developing the air transport industry though its capabilities have been shaped

by institutional change which will continue to act on China's international air transport policies. Unlike other industries such as petroleum where decentralisation has deprived the key regulatory functions of the bureaucracies, CAAC has managed to uphold its entire command and control over international air transport in terms of market entry and capacity. Although it is required to seek advice from other authorities to formulate a certain policy, it only involves a couple of such institutions as the SC and MFA, which in essence give CAAC policy guidance. Such a structural simplicity has enabled CAAC to devote majority of its resources to study policy issues rather than coordinating for a consensus. It has also allowed CAAC to press its own policy initiatives when negotiating with foreign countries such as the US, UK and Netherlands without much external resistance out of its control. The primary consideration for CAAC to take into account is whether the liberalization arrangements and the exchanges of traffic rights are corresponding to the nation's overall diplomatic and strategic policy objectives, namely, whether it is responding to China's Sino-US, UK and Netherlands policy.

8.6 Chapter Summary

This chapter has identified the factors at different levels and analysed how these factors converged on and interacted with each other to affect China's international air transport policymaking. To facilitate the process of analysis, it first of all revisited the theoretical model and summarized the agreements reached between China and its three counterparts. It then established the factors at international, domestic and institutional levels and examined how these factors interact with each other to shape the mindset of the policy makers who eventually formulate the trade policy and negotiate the best possible outcome. It argued that there are many factors that have a role to play in China's policymaking process with respect to international air transport, however, these factors are time- and circumstance-concerned, with some playing a bigger role at certain times but not all the time.

International environment tends to influence the nation's overall international air transport policy. Regional involvement enables the government to gain insight on how to manage the liberalisation issue while at the same time earns time for its enterprises to learn experience in international competition. Bilateral relations affect China's country-

pair market policies and determine to what extent the country accepts liberalisation initiatives. Domestically, more players including both state and non-state factors such as interest groups, government policy regime and political initiatives have demonstrated an impact on the nation's policymaking as well as its policy directions. Interest groups such as airlines, airports, and local governments, having recognized the impact of the policy change on their strategic directions, corporate interest and prospective performance in the market, have imposed their preferences to the policy outcome with an attempt to create a favourable operational environment which will help to enhance their competitiveness. They are able to channel their views to exert pressure on policy makers, though their success in lobbying is subject to their capabilities as to whether they are able to incorporate their policy preference to the overall national diplomatic and economic objectives and when they choose to deliver the lobbying. Individual firms within a singular interest group can either cooperate or compete on policy issues with their policy choice depending on their individual situation in the market and their understanding of the environment. Institutions such as CAAC have more authority in determining the nation's international air transport policy directions, though it is required to consult and coordinate with other government agencies for political guidance. Such coordination is less bureaucratic but effective to the extent that it ensures that negotiation strategies and outcomes reflect the nations' political position towards the specific country. These factors have evolved over the years, with some remaining to play a key role, some fading away, while others coming into existence as a result of the dynamics of both the external and internal environment. The changing nature of these factors has remained a dominant theme over the last three decades, which requires the policy makers to be aware, appreciate and embrace the environment and to respond with an adjusted policy outcome accordingly.

Chinese elite leaders at the top of the Government do not usually get personally involved in terms of international air transport arrangements unless such negotiation is regarded as a package to be used as leverage for a trade-off balance with a political significance. Instead, bureaucracies with direct responsibilities over international air transport take full accountability of the policy direction though advice and instructions are sought from other peer institutions.

This chapter also argues that international air transport policy, an element of China's national economic policy, exemplifies the nation's changing view towards liberalization of international trade. Over the years, China, although still a non-democratic country, has experienced a dramatic change in terms of its social and economic system, with its policy directions transformed from being protective and conservative to pro-competitive and advocacy to liberalization. The policymaking process is also becoming more open, transparent and plural, subject to the influence of various variables at different times and levels.

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Chapter 9 Conclusion

9.1 Findings of the research

Foreign trade exists in two dimensions. Outwardly, it consists of economic transactions in which goods and services are exchanged for money by persons or entities in two countries. Inwardly, it is a political process in which difficult choices must be made among competing values, priorities and objectives (Cohen et al, 2003). Foreign trade policy is a convergent point in that it is the end product of governmental decisions that need to reconcile economic and political objectives while at the same time, it facilitates the government to address its domestic and foreign concerns (Cohen et al, 2003). Trade policymaking involves reconciliation and trade-offs among a variety of economic goals and political necessities (Cohen et al, 2003).

International air transport has been especially politically volatile and always capable of arousing public interest, discussion and controversy (Snedden, 1981). It has remained one of the most debated topics in governments, attracting attention beyond its economic significance. For many politicians, air transport has become a battleground for conflicting political philosophies (Snedden, 1981). To ensure what has been achieved constitutes a “good international air transport policy” requires the government to sort through considerations of the best national interest, numerous conflicting intellectual viewpoints, compatible or competing domestic interests and foreign circumstances, while at the same time appreciating and honouring international rules and regulations that govern the global operations of the industry. Such multiple facets of the subject matter make the policymaking of international air transport a more sophisticated political process with a significant economic substance.

Studies on international air transport have been numerous with the majority focusing on the economic impact of deregulation since 1978. Research on international air transport as an international trade in services has been more recent and, in particular, on policymaking in the domain of international trade in services has been limited, fragmented and unsystematic. Examining China’s international air transport policymaking from an international political economic perspective is a brand new endeavour. This research is aimed at identifying the factors that have had an impact on

the country's policymaking process, establishing whether these factors are evolving over the years and determining how they are interacting with each other in leading to the policy outcome per se, hence, shedding light on the country's international trade policymaking and its international behaviour.

To this end, the following objectives have been identified:

- To review China's international air transport policymaking process in order to identify what are the factors that affect the decision-making process;
- To establish whether the factors stem from the international environment, domestic considerations, or result from institutional and individual behaviour;
- To discuss, examine and analyse these factors to determine how they interact with each other and have an impact on the policy makers, leading to the policy output;
- To examine and analyse how the policy has evolved over the years and to establish whether the factors are changing;
- To determine which factors have played and are still playing critical roles in the policymaking process; whether their roles are changing and whether such changes are time-environment related;
- To make recommendations to governments, industry aviation organisations and other stake holders regarding best practice for the benefit of the industry, the nation and the global community as a whole; and
- To further the understanding of China's international trade policymaking process and shed light on the understanding of China's international behaviour.

In attempting to achieve the above aims and objectives, this research has applied the Micro-Macro Linkage Approach to China's international air transport industry, taking three country-pair markets, namely China-the US, the Netherlands and the UK as case studies for an intensive analysis. Through the examination of data gathered through observation, revision of the historical files and records, and in-depth interviews with those who have participated in the process of policy making and been personally involved in the bilateral air services agreement negotiations, this research has led to the following findings, compared with other studies in the realms of international trade

policymaking, whose characteristics are elaborated in more detail in the following paragraphs.

- The factors at all levels, i.e. international, domestic, institutional and individual, all have a role to play in the policymaking process, although the weighing of each factor remaining to be determined due to the shortage of an objective methodology of measurement;
- The factors identified in this research have been evolving over the years with new variables emerging as environment changes. They are found to be time- and circumstance-related, namely, some factors function at certain times in certain circumstances but not necessarily on other occasions;
- The industry regulator at ministerial level, namely CAAC in this case, is the key initiator, negotiator and administrator in the process of policy formulation and implementation. Although it requires coordination and consultation between institutions and agencies under the SC structure, it is not as fragmented as the case in energy issues discussed by Lieberthal and Oksenberg in 1988. The state elites are not noticeably personally involved in the process of daily management though their attention might be drawn occasionally at certain point where a compromise solution has been sought;
- The policymaking process in terms of international air transport is becoming more dynamic, being more open, plural and transparent involving more stakeholders seeking for a fair and balanced consideration of their views and comments.

9.1.1 Factors at all levels that have influenced China's international air transport policymaking

Over the last three decades, radical changes have taken place around the world. International air transport as a heavily regulated industry has now become liberalized with the majority of economic restrictions being removed through the US's Open Skies initiatives. According to ICAO, by 2009, at the bilateral level, a total of 167 Open Skies agreements had been concluded involving 101 Member States. These arrangements together with regional liberalized agreements covered about 32 percent of country-pair

markets with non-stop international passenger services and almost 57 percent of the frequencies offered (ICAO, 2010). At the national level, some 16 Member States adopted Open Skies policies, which have liberalised foreign airlines' market access to their territories, in whole or in part, on a unilateral basis. Some States have launched review processes of their air transport policies in light of the global trend toward increased liberalisation (ICAO, 2010).

Although China is not one of those countries that have adopted fully liberalized policies with respect to their international air transport, it has made significant progress in removing the constraints on air transport operations, resulting in a robust industry with a sustained growth. The country has transformed itself from an enclosed, centrally-controlled economy to an open, market-driven economy. As it is integrating into the world economic system, the factors influencing its policymaking process have also evolved with new elements emerging and being actively interacting with each other, making the process more plural, dynamic and more prone to external influences. In addition, the factors tend to be time- and circumstance-constrained, with some playing its role in certain environment at certain times, but not necessarily in other instances.

This research has identified the following factors at all levels that have had an impact on China's international air transport policymaking. Intergovernmental organizations such as ICAO and the WTO have been identified at the international level as decisive factors in influencing China's overall international air transport policy direction at national level. According to Simmons and Martin (2002), the international political system including international organisations, international law, informal norms, as well as non-intergovernmental organisations, is an important structure that constrains and shapes a country's foreign policy. International considerations are factored prominently into a nation state's decision-making that domestic critics are irritated that too much attention is being given to them, with a state's own identity being increasingly shaped by the international political context. When trying to balance the two ends of the spectrum, i.e. domestic benefits and international obligations, decision-makers are caught in the condition of interdependence, where they need to seek the best second to none solution.

China's entry into the WTO in 2001 has propelled the country into formulating policies and laws that are in compliance with the world system. WTO membership forced the country's very top leaders such as Jiang Zemin and Zhu Rongji, who were the state President and Premier at the time, to take proactive measures to implement the commitment, thus leading to a fundamental structural change in society, the system and the industry. Similarly, ICAO also caused the country's air transport industry to respond to its call for liberalization, which took immediate actions in issuing government directives and regulations to remove the economic constraints on air transport operations.

Dealings with ASEAN and the economies in Northeast Asia including Hong Kong and Macau SARs have been identified as an important factor at the regional level. They are not only geographically closer to China but are politically important to the country and economically interdependent with it. Liberalisation between these economies and the US, between them and China, and between themselves have produced both a positive and negative impact on China's view towards Open Skies in bilateral markets, forcing the government to re-evaluate its policies towards the industry leading to the adoption of a progressive approach to relaxing the restrictions on the industry. Although to what extent the impact of this kind of relationship on the country's overall air transport policy is yet to be determined, it certainly has influenced the policy outcome and negotiation results in the China-US market.

Relationships between China and the US, the EU, the Netherlands and the UK respectively have been identified as decisive factors at the bilateral level exerting influence on the country's policy in respect of the particular country-pair market. Political relations between each country and China have affected their political stance and hence their economic policies and, explicitly, air transport policy. Establishment of diplomat ties certainly led to the establishment of air links, while disagreement and divergent views on certain politically-sensitive issues has led to the suspension and interruption of air links. When economic relationships become closer and interdependent, demand for air transport grows rapidly. The ever growing bilateral trade has stimulated the desire for closer air transport relations, requiring governments at both ends to respond to market forces. The trade relationship, no doubt, has influenced the

preparation, objectives, strategy and outcome of each round of negotiations, hence, affecting the mechanism of market liberalization, determining the pace of the liberalization of the particular bilateral market and the method the liberalized arrangements are to be introduced.

At the domestic level, the central government's national policy initiatives have been identified as a critical factor determining the policy direction of the air transport industry with respect to international operations. This perhaps is a reflection of the special features of China's social and economic system in that bureaucracies and institutions are obliged to formulate industry-specific policy guidelines to mirror the strategic mission of the central government. CAAC as a government agency has accountability to develop industry policies and to ensure these policies facilitate and support the overall national policy, politically, strategically, and economically. The central government plays an exclusive role in determining the nation's policy directions, which industry policy must mirror. In addition, the central government's decisions about political and economic reform of industries exert a great influence on the industry regulator's strategies and tactics as to to what extent their policies should protect the industry and to what extent their policies should promote competition by creating a fair playing field. The relationship between the central government and the industry regulator is an important element in understanding the impact on the industry's policy outcome.

Another factor that has been identified at the domestic level is interest groups which include airlines and airports, as well as local governments. They have had an impact on the policymaking of China's international air transport industry, in particular on the objectives, strategies and results of the negotiations in country-pair markets. These interest groups exert a great impact on the government's policy choice rather than shaping the ideology and mindset of individual policy makers, namely by influencing the objectives, strategies and results of each round of bilateral negotiation. However, whether they will be successful in persuading the government to take decisions in each individual's best interest is subject to many factors, which include the following:

- Whether they have effective access to the policy makers;

- How they present their case;
- Whether their request corresponds to the national strategic and economic policy direction;
- Whether their request reflects the requirements of the local economic development goal and facilitates local economic growth;
- The timing of their lobby, namely when they lobby for what; and
- To whom their lobbying is directed.

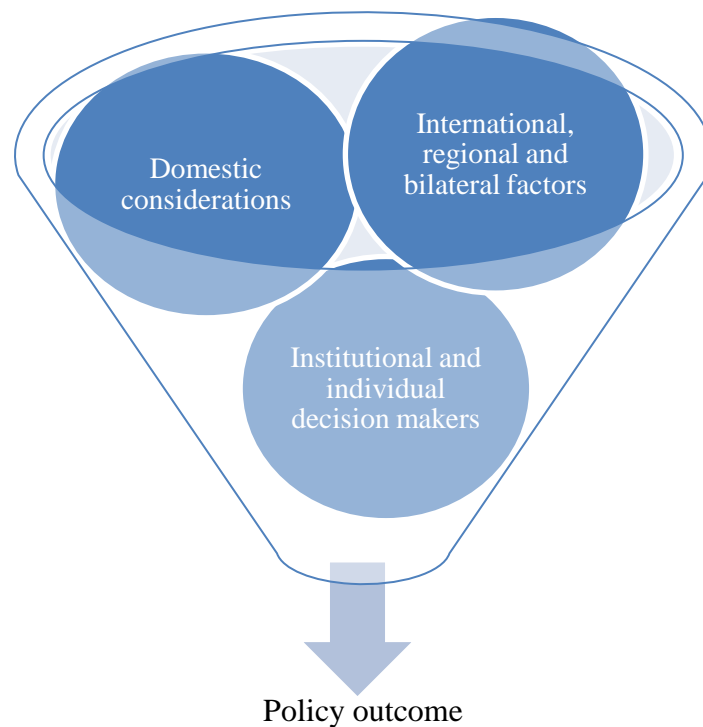
One of the differences between China and the industrialized countries in the West in terms of the influence of industry interest groups is that private business plays a bigger role in western countries, while in China, it is the state-owned enterprises that are more active in their lobbying. Greater constraints have been imposed on policymakers' preferences for the regime and for their own survival in the foreign trade policy making process, resulting in more demands and viewpoints that require to be taken into account in hammering out the policy outcome (Lai, 2010).

Media with a special focus on air transport industry has also been established as a factor for analysis, though the findings have revealed that the aviation-oriented media has not played a role in the country's liberalization policy.

At the institutional level, the key factor that has been examined is CAAC, as well as individual bureaucrats, though other organizations involved in the process are discussed. As an institution charged with responsibility by the SC for regulating the air transport industry, CAAC has played a pivotal role in formulating the nation's air transport policy. It decides how, when representing the Chinese government in the international community such as ICAO, to present the nation's policy and directions responding to the international environment. It decides how industry policy should reflect the national government's call and initiatives. It has to evaluate all the requests from interest groups and determine which should be met and which disregarded. It takes sole responsibility for formulating negotiation strategies and tactics and is accountable for the negotiation outcomes. It also has to implement industry policy and negotiation results to ensure that what is bargained will bring the anticipated benefits to the industry, the region and the nation as a whole.

Although CAAC has experienced several restructurings over the last three decades, its main responsibilities have remained unchanged. Due to the special features of the social system in China and the airline industry, CAAC, unlike the country's other industry bureaucracies whose powers are fragmented and shared with one another, has the sole responsibility for formulating the nation's international air transport policy, though consulting with the MFA from time to time. It is the focal point where all factors, no matter at which levels, meet, interact, converge and are filtered through the "black box". It is here that policy is debated, crafted, formulated and implemented (Figure 9.1).

Figure 9.1 Factors at all levels and their interactive impact on the policy outcome.



Source: compiled by the author

9.1.2 Evolution of factors and their changing nature

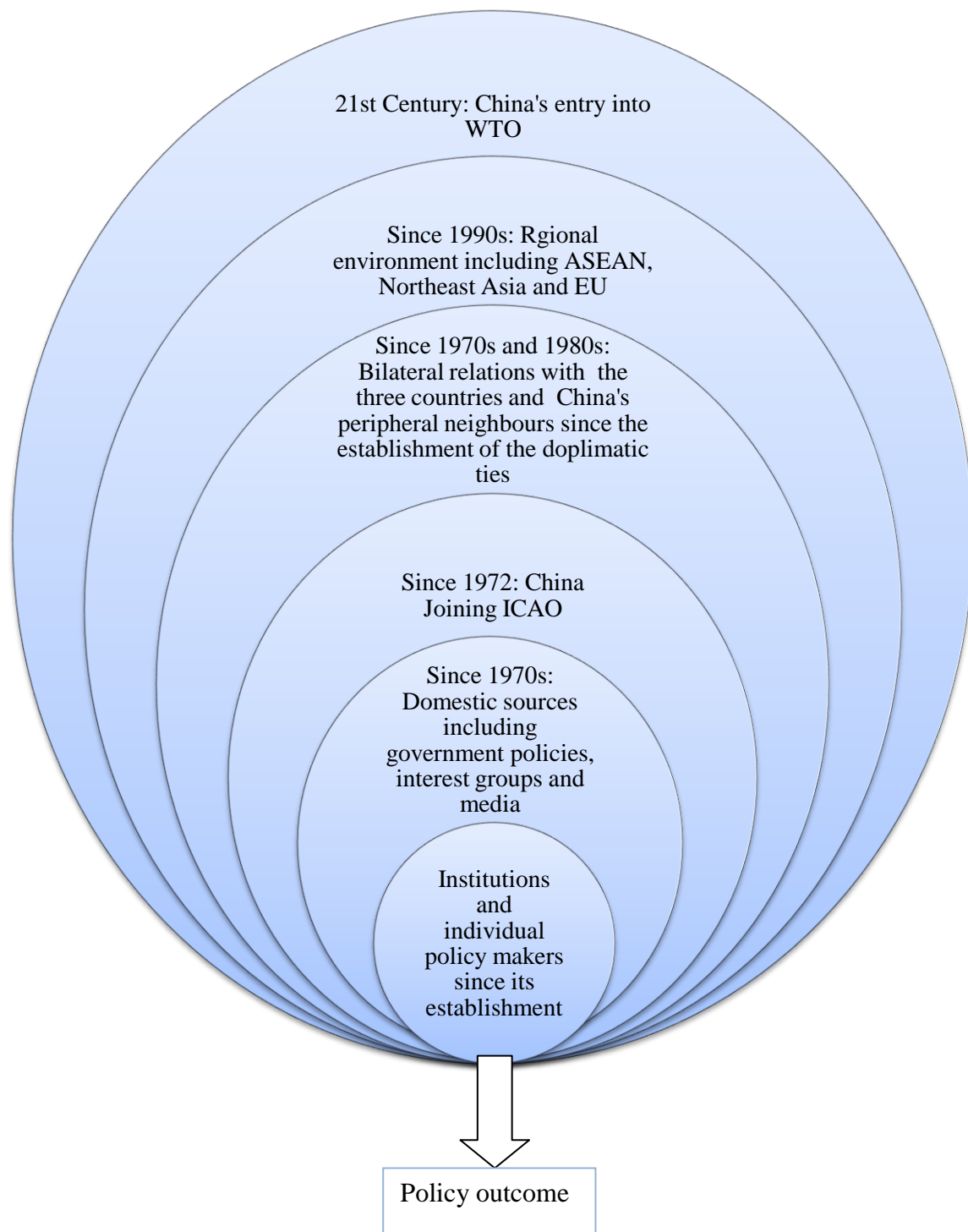
The old French aphorism goes that the more things change, the more they remain the same. Constant change is the universally unchanged feature of the natural world as well as of society. So is the policy agenda of the nation state, which will never stop expanding, either in content or in scope (Cohen et al, 2003). They are refined, adjusted,

adapted and revamped to reflect the changing nature of environment based on the feedbacks and results of implementation. The changes are additive, incremental and continuous rather than abrupt, radical or transformational (Kong, 2010).

This research has established that the factors influencing China's international air transport policymaking is of evolving nature. The international regime has had an unprecedented impact on China's international air transport policy ever since the country became a member state of that particular organisation, whose rules and regulations are legally binding. This is best exemplified by the country's membership of ICAO since 1972 and the WTO since November 2001. Such a binding status forces the country to fulfil its obligations, which have had a fundamental impact on the country's political, legal, regulatory and economic systems. This element is not a new factor in influencing the country's international air transport policymaking although the weight of the role that both ICAO and WTO have played differed substantially. When comparing these two, the WTO membership is more a changing agent that did not exist before the 21st century, which apparently has played a bigger part in propelling China to change its protective regime for a liberalised mechanism. Regionalism has had a great impact on China's consideration of its political and economic policies as geo-politics not only affects a nation's stability but also its economic prosperity. Participation in region-wide political and economic programmes enables the country to gauge the external situation and test its policy initiatives to gain experience at the global level. This factor is of evolving nature as its influence had not been exerted before 1997 when China was not actively involved in regional forums. Bilateral relationships have played a non-replaceable role in the country's international air transport policy in country-pair markets, if not at the national scale. It directly affects the country's strategy, negotiations and outcomes applicable to that particular country-pair market. This kind of bilateral relationship has remained an ongoing factor ever since diplomatic ties were established, namely since 1980 for the Sino-US market, 1976 for the Sino-Netherlands market and 1979 for the Sino-UK market. Exchange programmes, industry training and political summits and dialogues have become a source of influence, which had not entered into the formula until after 2005. Different programmes have apparently exerted different pressures on different country-pair markets, which are subject to how the programmes are managed.

Interest groups are able to get their voices heard through various channels and their preferences accepted through their persistent and timely lobbying, though subject to the circumstances as to whether their preferred policy outcome is corresponding to the policy direction of the central government and the industry regulator. Those who used to be inactive are getting more proactive in the process of lobbying as the country's political reform is getting more intensified. According to this research, such lobbying started to be perceived and reflected in the policymaking process from 1987 when the airline industry was initially restructured. Local governments have been active since the 1980s although their focus of the lobbying has been evolving to reflect their local economic interests. Airports as interest groups had not been perceived until after the 21st century when they were spun off CAAC's control. CAAC has always been a key factor in influencing the policymaking of the industry though the procedures it follows has been different from time to time. Elites that are the top heads of the state and government tend not to be involved in international air transport policymaking, unless the arrangements are considered to be an element of a package that will have a bigger impact on the country's overall political and economic significance. It is the bureaucrats at institutional level that are engaged in day-to-day management, though their final decisions are subject to the consent of officials at a superior level. Individual decision makers at bureaucratic levels are exposed to all sorts of influences internationally, domestically and institutionally and are affected by their personal experiences, perceptions and interpretations of the external environment. Policy choices, negotiation strategies and negotiation outcomes become a combination of the consequences of the interaction of these factors (Figure 9.2).

Figure 9.2 Factors and its evolution that have an impact on the policymaking process.



Source: Compiled by the author

9.1.3 Industry regulator as the key policy initiator and formulator

The research has yielded that international air transport policy, though an element of the nation's strategic trade policy, is not in the agenda being determined by the state elites at the top political bureau level. Rather, it is formulated at ministerial level, in this case the CAAC, which is charged with the responsibility of regulating the industry, although its title has been slightly changed more or less, its structure has been altered and its status within the country's political system adjusted. This corresponds to Kong's finding (2007) in his study on China's petroleum policymaking that it is the government agencies at ministerial level that initiate and formulate policy directions and oversee its implementation. The industry regulator has been a key change agent in this process, enabling the policy change to take place across the country. This is also in line with one of the conclusions Dougan (2002) has drawn from his studies about China's civil aviation industry, despite mainly focusing on domestic issues and manufacturing aspect, that the country's elites were not noticeably involved in matters with respect to civil aviation (Dougan, 2002).

Unlike the US where the President and House of Senate, the EU where the Council of Ministers would from time to time attend to international air transport policy issues such as liberalisation and Open Skies, little evidence in this research has suggested that the country's elites or very senior top leaders at the central government level such as the Politburo or the SC have played an active role in its international air transport policymaking process. Such issues have failed to attract their attention and focus, who have to respond to complex international and domestic challenges and threats stemming from the country's political and economic reform as well as globalisation. It is not deniable that State Councillors have been involved on exceptional occasions. However, this happens only when a compromised solution is required for the benefits of achieving an overall agreement between the countries concerned.

This finding is in contrast to Feng's (2006) conclusion when he studied the country's resumption of its membership negotiation with the WTO, who claimed that it was the country's elites who have made such strategic decisions. His investigation revealed that it was these elites who were able to weather the domestic debate on the subject matter

by generating a positive image of the WTO in the public mind through the party-controlled media and by keeping various counter-arguments of the official line within the academic and professional spheres. The bureaucracies which represent the interests of the industries that would be affected by membership of the WTO, instead, played a destructive role in the process by bargaining respectively for their own favourable deals and, when necessary, obstructing the formation of the consensus required for moving the progress forward by exploiting the fragmented structure of the system, thus causing the process to be stalled for quite some period of time.

Despite CAAC has to consult with and seek advice from other institutions, the decisive and pivotal role the Administration has played in formulating, negotiating and administering international air transport policy has remained unchanged nor challenged. As one of the bureaus affiliated to one of the ministries under the direct control of the SC, CAAC has its own particular missions that it should pursue with its administrators and director generals representing its views.

When policymaking is made at this level, the structure of the system, and the position and experience of the officials within the system exert significant impact on the policy outcome. This finding is not in conformity with what Lieberthal and Oksenberg (1988) found out in respect of the policy making in China on energy issues. Lieberthal and Oksenberg concluded that the decision making on energy issues in China was a fragmented process involving quite a number of institutions such as inter-agency decision-making bodies and industry bureaucracies, which were only loosely coordinated. These organisations invested significant resources in bargaining with each other in order to build consensus, thus, making the process diffused, protracted and disjointed. To enable the policy to be passed as national policy, the bureaucrats at ministerial level were capable of manoeuvring the situations to force an issue onto the agenda of the highest leaders at the top Politburo level.

9.1.4 The dynamics of the policymaking process

In line with the political and economic change, China's policymaking process has evolved from being a closed, singular, and rigid process to an open, plural, dynamic and transparent process. As China has integrated more closely with the world economy,

distinction of domestic and international economic issues have become blurred that the country's leadership are increasingly turning to both domestic and international arenas for solutions for domestic challenges (Kong, 2010). With more actors being involved, the policymaking process has become an absorptive and fluid mixture of bottom-up and top-down course. It has become an interactive two-way street that is diffusive and participative (Kong, 2010). This is reflected in Kong's analysis of China's international petroleum policy as well as documented by other researchers such as Zeng.

In the 1970s, policies with an international aspect, such as international air transport were determined exclusively by the competent authorities with primary consideration being given to achieve the country's strategic, military and diplomatic objectives. The monopoly of international policymaking by the authorities has been shattered since the late 1970s as the country embarked on its economic reform and became increasingly exposed to the external environment. More factors such as interest groups including industry enterprises, local government, think tanks, media, political forums and dialogues have been brought into the policymaking process, which has become decentralised, pluralized, and more dynamic. The interaction of these factors in the process is more active, and closely knitted than that in any other industries due to the special characteristics of the international airline operation since after the World War II. Industry policy makers who are industry bureaucrats at institutional levels have developed an open view and embraced divergent environment and would formulate policies and achieve policy outcomes taking into account all factors that they deem important.

What is worth noting is that international elements are playing an increasing part in this policymaking process. This is due to the fact that international air transport requires that both governments, airlines and airports at either end of the country-pair market to coordinate, collaborate, and cooperate effectively to optimise the policy outcome. Cross-border lobbying has become trendy and taken different format, in order to realise the benefits of the liberalised trade policy. For example, foreign government or industry corporate would get local governments and stakeholder to be involved to advocate the voice for liberalisation while at the same time tabling a tough negotiation plan. This

kind of round-about soft strategy works well as the Chinese government has been convinced by domestic forces that it is obliged to support its local economic growth.

Nevertheless, no matter how the process evolves, politics will continue to shape economic policy (Cohen et al, 2003). The policy outcome always represents the end product of choices that must be made between conflicting yet legitimate values. Different self-interests will invariably continue to produce conflicting policy recommendations, each having some degree of wisdom and truth but not enough of either to attract universal support (Cohen et al, 2003).

9.2 Originality and contribution to knowledge

An original contribution to knowledge is a prominent requirement for doctoral research. Original research is regarded as both the creation of new knowledge and an innovative approach to the discovery of that knowledge (Liley and Mullin, 2005). Originality in research does not necessarily mean invention out of a vacuum but can be the gathering-together of the known elements that hitherto have been kept apart, thus leading to the generation of new ideas, new facts and new evidence (Finn, 2005). Through a systematic, synthesized and critical approach, the researcher is able to uncover new knowledge either via the discovery of new facts or via the innovative re-interpretation of known data and established ideas (Murray, 2002), thus introducing new concepts and theories that are regarded as novel, creative and innovative that contribute to knowledge.

This research is an attempt to treat international air transport as an international trade in services and to further the study of trade policymaking from a political economic perspective. It focuses on three country-pair markets and examines the factors that have influenced China's policymaking process when liberalizing its international air transport market, how these factors have interacted and evolved over the years. The significance of the study is that it serves as a good example to illustrate how China's political and economic reform and current globalisation trend have affected the country's political system. Furthermore, it helps to reveal specific characteristics of the country's political system, which itself has been involving. More than 30 years of reform has transformed China from an enclosed planned economy to an open and market economy.

Globalisation has brought the country more exposed to international environment. In this kind of dynamic circumstance, the Chinese government has also adjusted its roles and functions to become more adaptable to meet both domestic and international challenges. Specifically, this research has made following contributions to knowledge:

First, traditionally, the study of policymaking in air transport has been taken as an independent subject matter, with researchers discussing how domestic politics have driven policy changes. Majority of research in this category has concentrated on individual countries treating the subject matter as an object of domestic politics. In contrast, this research is one of the first that discusses a nation's liberalization policymaking by treating international air transport as a trade in services. It has taken three country-pair markets as case studies and examined almost all rounds of bilateral negotiations since the first ASAs were concluded with an attempt to understand how policy has been made and what are the factors that have an impact on the policymaking process. This researcher has been able to identify the factors at international, regional, bilateral, domestic and institutional levels, examine how these factors interact with each other to exert influence on the policymaking process, establish how these factors have evolved over the last three decades and argue why the policy outcome at the national strategic level is a reflection of both international and domestic situations and circumstances, and why the specific policy outcomes at bilateral country-pair market level is a trade-off of various considerations. The factors are proved to be time- and issue- related, namely some factors have a strong influence at certain times but not all the time, some elements have an impact in one situation but not in another, while other variables function in one country-pair market but not necessarily in another.

Secondly, this research is one of the first to study China's international trade policymaking, taking the air transport industry as a case study, which is a highly commercialised international business by nature. Studies on China's policy making have been relatively recent, with the works of Lieberthal and Oksenberg (1988) being the most influential thanks to their formulation of the FAM, which claimed that a complex, and at times highly fragmented, structure of authority existed in industries between different executive and administrative/bureaucratic levels of the system. The fragmented, segmented, and stratified structure promotes a system of negotiation,

bargaining and the seeking of consensus among affected bureaucracies, resulting in the policymaking process being disjointed, protracted and incremental (Lieberthal and Oksenberg 1988).

The rapid growth of China's economy, especially its advocacy of foreign trade, has inspired a handful of research in the country's foreign trade policymaking since the 1990s. However, these efforts have been either directed to understanding the issues behind trade conflicts or the rationale of trade relationships. A few pioneers have touched on trade policy issues but render themselves to seeking for the driving forces for policy change from domestic sources, such as Zeng (2007). This is attributed to the lack of a comprehensive theoretical framework which will enable the researcher to examine the subject matter from an all-embracing approach. Feng's (2006) analysis on the politics of China's access to the WTO is a valuable attempt at addressing the country's policymaking from international, domestic and bureaucratic perspectives, which sheds an insight on the subject matter. However, the researcher has not advanced any theoretical formation out of the investigation.

There is also some research done with respect to China's air transport industry, which analyzed the impact of the nation's economic reforms on the industry but with almost no mention of the political side of the reform, namely how China's international air transport policy is formulated and what are the driving forces for policy change. Digging deeply into the literature, one can find bits and pieces which mention briefly China's international air transport policy and its evolution, however, either the policy is treated as a political background which gives the rationale that leads to the economic change, or is regarded as a driving force for industry restructuring. There are two exceptions, though, by Dougan (2002) and Williams (2009) respectively. Dougan (2002) analysed China's policy making process in the aviation industry, which covered both domestic air transport as well as the manufacturing sector. Regrettably, the research did not include China's international air transport, which is an integral part of the country's aviation industry and is taking a growing proportion of its overall activity. Williams (2009) traced the larger motivational and political forces that have underpinned the reform process of the industry on a generic term without applying any

theoretical models to his analysis, hence failed to present theoretical implications to the future studies.

This research provides a more meaningful attempt at analyzing China's foreign trade policy, taking one industry as a case study and examining policy change over a time span of thirty years. By applying the Micro-Macro Linkage Model to the industry cases with a longitudinal approach, the researcher is able to establish whether there is a causal relationship between the variables and the policy outcome, and to identify which of the variables has led to the policy outcome. It also enables the researcher to establish if there is any pattern in terms of policymaking and policy change. Although the research did not lead to any substantial theoretical formation, it is a significant effort in testing the vigorousness of the Model in different settings. It has produced a substantial amount of empirical evidence demonstrating the relevance of the Model, which hopefully can be developed to generate theories to be used to analyse China's foreign trade policymaking.

Thirdly, this study has adopted a Micro-Macro Linkage Approach involving case studies with an attempt to unfold the black box of the policymaking process. As discussed in Chapter Three, the Micro-Macro Linkage Approach was developed by Zhao (1996) to examine China's foreign policymaking to understand how variables at both the micro and macro levels have an impact on the policy makers, shaping and crafting their ideas and mindset resulting in a particular policy choice. He applied his formula to the case of China-Japan relations from 1979 till 1995 with respect to Japan's ODA to China including government loans, grants and technical aid. He examined how the Chinese and Japanese governments faced different external and internal environments which exerted different pressures and how the two countries respectively developed their domestic win-sets featuring overlapping interests, hence leading to successful collaboration on some massive economic projects (Zhao, 1996). Since then, the Model has not been actively applied to other cases though Zhao suggested a very comprehensive agenda for further research, including case studies on bilateral relations with other countries and key policy decisions. The last decade has seen a handful of studies on China's foreign policymaking, including foreign trade policymaking, with domestic factors being the overwhelming focus. Yet, none has ever taken on Zhao's

Model with either empirical evidence or testing its validity and vigourousness in a different situation. From this perspective, this research is a meaningful effort at applying the Model to new areas.

Fourthly, this research has generated a large amount of new empirical findings at both the micro and macro levels, which are not available for either academic researchers or industry practitioners with respect to China's international air transport industry, in particular the Sino-US, Netherlands and UK bilateral markets, as well as the markets between China and its peripheral neighbours in ASEAN and Northeast Asia. It was the sincere hope of Zhao (1996) who suggested that more research should be conducted leading to empirical findings at the micro-level so as to enable a full coverage of the interactions between different levels with regard to foreign policy choices, hence contributing to a theoretical framework (Zhao, 1996).

For this study, empirical evidence is produced at both the macro and micro levels for the three country-pair markets. At the macro level, the relationships between international organizations and China and between individual countries have been discussed. At the micro level, domestic sources such as societal factors, institutions, individual decision makers, as well as their relationships with each other have also been examined. For example, for the Sino-US market, although a couple of studies have been conducted, they either focused on the countries' Open Skies negotiations in 1995 and 1999 (Meyer, 2002) or analysed the economic impact of the bilateral arrangements on the air travel market (Yu, 2010). For the China-Netherlands and China-UK markets, to the best knowledge of this author, there is little academic research conducted to date, though several papers such as Liang (2004), Lu and Fisher (2010) have looked into the China-EU air transport market which included some preliminary information about the two country pair markets. From this perspective, this research is the first to look into the China-US market analyzing the negotiations on liberalizing the market over the last 30 years. It is also the first to examine the China-Netherlands and China-UK markets.

It can be said, therefore, that this research has generated more empirical evidence at both the macro and micro levels and examined the co-relations between the various influencing factors at both levels. Though there are some limitations when applied to

the cases for analysis, as discussed in the preceding parts of this chapter, the research has revealed significant empirical evidence and drawn some interesting conclusions, some of which are corresponding to what other researchers have established while others are in contrast to the previous research. From this perspective, this study has contributed significantly to the advancement of the Micro-Macro Linkage Model.

Last but not least, this research has hoped to provide a fair, objective and comprehensive presentation of China's international air transport policy. Although there is quite some literature looking into China's international air transport industry analyzing airlines' and airports' strategies, their performance and reactions to the policy change, when discussing the country's government policies, regulations, directives and procedures and their impact on the industry, there have existed quite some errors, which can be attributed to the inability of the researchers to have access to the files and records of Chinese aviation organizations. The author of this research, on the contrary, has been able to negotiate access to the government files, conduct personal interviews with senior officials and management of both government and industry, and carry out on-site observations, which, to a great extent, has safeguarded the authenticity and objectiveness of the empirical materials. These findings as well as the discussions, analysis and conclusions as presented in preceding chapters will hopefully help to improve understanding about China, its aviation industry, its policymaking process and its international behaviour.

9.3 Limitations of the research

Due to the pressure of time to accomplish this research and the constraints of financial resources available, this study, though having made some achievements, is still only a preliminary attempt at unfolding China's trade policymaking and its practice in the international air transport industry. The following are the limitations identified:

- The Chinese government has a very stringent regime of managing its files and records. For this research, either some of the historical documents are not available for external access due to confidential concerns or have been filed with the central management office which denies access for any purposes. For example, the researcher could not locate any official records with respect to the

Sino-US market before 2003, or any official records with respect to China-Japan, other ASEAN countries and Mainland China-Hong Kong. This to some extent has refrained the researcher from developing justifications for the rationale of liberalizing the markets with these countries and examining to what extent these negotiations are related to the three country-pair markets studied in this thesis;

- Other aviation organizations tend to refuse any external access to their operational performance records too for various reasons, one of which given is that such information is highly commercially confidential. Though OAG and other sources from the public domain are able to provide some data, they could not enable the researcher to trace the real historical performance of the airlines and airports during a specific period of time for the benefit of the discussion on a particular issue. The shortage of such information precluded the researcher from justifying the intention of the individual member of the industry interest groups when they presented a positive or negative lobbying position, and thereby arguing to what extent the individual members of the industry interest groups are able to present a convincing business case to the policy makers in their favour;
- Some interviews could only be conducted via telephone or email due to the lack of financial support for the research. Though quite some telephone interviews proved to be very effective in revealing valuable information, those done via email were not very satisfactory in that the information provided was not intensive or comprehensive enough. Email interviews do not allow the researcher to explore the rationales of the answers given or reflect on the answers to exploit further and more extensively;
- Another issue is that this research may not be available for public view for a certain period of time (likely to be two to three years after completion) due to the confidentiality commitment made with certain organizations, which require that certain protocols to be followed. This to some extent will limit the impact of the research on the subject matter in the academic arena, as well as limit the influence on industry practitioners;
- Quantitative methods have not been applied in this research, though this can be

used to analyse the data about the performance of airlines and airports as well as individual views on the liberalization of international air transport market. They can also be used to measure the weight of each and every factor that has been identified. This is due to the fact that factors are issue- and time-constrained without consistence. Another challenge is that, to the knowledge of this researcher, there is no existing formula or template to allow the evaluation and assessment of the factors, which can be applied to determine a suitable weighting, as Lai (2010) pointed out it remains an issue as to how to measure the impact of each factor in the policymaking process.

9.4 Suggestions for future research

China is now the second largest air transport market measured by RPK, just behind the US (ICAO, 2008). It is also the second largest economy measured by GDP, just behind the US. It is also crowned now as the world's top trading nation with the biggest volume of international trade. A better understanding of the country, its international behaviour and its relations with the rest of the world is apparently required for the benefit of the world. Zhao (1996) identified two broad areas for further study, which included more precise research into developing the micro-macro analytical line and into specific cases-contingent studies in the domain of foreign policymaking by applying the linkage approach. Taking into account the current study, the following areas have been identified for further research.

- ICAO as a governmental organization has more authority in regulating the international air transport industry from a safety and security perspective, though not from an economic perspective. As the WTO has categorized international air transport as an international trade in services and successfully included liberalization of the industry into its multilateral negotiation regime, though only moderate progress has been made, does such an arrangement have an impact on the policymaking of the member state governments? If so, to what extent will such an impact affect the individual member state's policymaking process and its policy agenda?
- International air transport as an international trade in services has its own

characteristics, which are unique to the industry. For example, airlines are required to establish a network to be able to achieve economies of scale and density. Liberalisation of bilateral markets on a country-pair basis is not necessarily adequate to allow airlines to optimize their operations. Does this specific feature of the industry have an impact on both government's policymaking and airlines' lobbying practice? If the answer is yes, then how do the airlines exert their influence and to what extent are their arguments able to convince the governments to accept their views?

- Political summits, dialogue, exchange programmes such as training for industry personnel (in contrast to the academic exchange programmes for university and research institutes) have been new phenomena since the start of the 21st century. They have facilitated communications and promoted mutual understanding while at the same time becoming a source of influence for a nation's international policymaking. Yet, how this practice has become a source of influence and to what extent the influence has been perceived and accepted has remained unknown from an academic perspective. This would be a very interesting area for further exploration.
- Airlines as an interest group are different from other industries when lobbying the government in its policymaking process. This can be attributed to the fact that airlines have been involved in policymaking and negotiations from the first day that international air transport started to take shape in 1944. This is particularly true in China as the regulator and airline operators used to be one organization with two brands. Developing its corporate culture out of this peculiar circumstance, how are airlines, compared with other industries in China, exerting their influence on the policymakers? What are their specialties in conducting the lobbying and to what extent does their lobbying carry a bigger or lower weight compared with other interest groups such as airports, local governments, local communities and other stake holders?
- CAAC as the sole industry regulator with respect to air transport until recently has not been involved too much in bureaucratic bargaining in the determination of the nation's international air transport policy, though it needs to consult with the MFA regularly and constantly when dealing with a specific country-pair market. CAAC

also controls the air transport industry vertically without much interfering from local governments and other bureaucratic institutions in terms of air transport services. This is contrast to other Chinese ministries whose authority is fragmented with tens of others bureaus being involved in the process of coordination before seeking a consensus and with local governments who usually have an economic stake in the business. Consequently, does this kind of vertical control of the industry shape CAAC's approach to policymaking compared with other industries? If the answer is yes, then how different does CAAC behave when compared with other agencies, what are the features of the policymaking process of both CAAC and other ministries, and to what extent do these different features have an impact on the policymaking and policy outcome? To what extent do these kinds of institutional features influence the nation's policymaking? To what extent does this have an impact on the negotiations with counterparts and to what extent can key individual negotiators manipulate the situation to achieve the best policy choice?

- More and more Chinese bureaucrats have overseas experience. Some research has claimed that personal experience has a positive role to play in shaping their ideology and gradually changing their ideas and mindset. Air transport is an internationally standardized business with its employees having ready exposure to global influence. Pilots as well as other professions in the air transport industry already have a good knowledge of the international standards. Does this exposure have an impact on the policy makers' mindset, thus affecting the policymaking process? To what extent does this overseas experience, standardized professional background and international exposure have an impact on the policy choice in terms of international air transport, especially on a particular country-pair market?
- Kim (1994) has argued that a list of laundry-list-like factors should be avoided when assessing the influences of the identified variables. However, the question remains to date how to measure these factors? As this author has admitted one of the limitations of this study is the lack of quantification in the gathering and analyzing the data, it is therefore suggested that a mechanism should be worked out so as to measure the identified factors in order to determine their weight and influence. This can be very challenging as the variables established out of each empirical research can be totally different, thus causing difficulty in getting to an agreement as to what

can be defined as a causal factor and what can be a consequence.

To summarise, this study is only a preliminary attempt at applying the Micro-Macro Linkage Model to China's international air transport industry in order to examine its liberalization policymaking. By taking three country-pair markets as case studies, this research has identified factors at international, regional, bilateral, domestic and institutional levels and examined how these factors have interacted with each other to influence the country's decisions in liberalizing its bilateral air transport markets. Albeit with some limitations, this research has revealed significant empirical findings and drawn some interesting conclusions in determining how the decision makers have come to their policy choice. It is a meaningful effort in generating some empirical evidence required for advancing a theoretical model and opening up new agendas for the study of China's foreign trade policymaking. As a test of this integrated approach in a different environment to that tested by Zhao in 1996, this research is hopefully contributing to the understanding of China and its international behaviour, as well as to the further development of this innovative analytical framework.

9.5 Recommendations to the government and industry

Decision making is an art rather than a science. Process affects substance (Cohen et al, 2003). By examining the policymaking process, we are learning to understand how the system works, how people behave and how to improve the performance and results. With this view in mind, the following recommendations are made to the government and industry:

- The consultation process should be systemized and legalised with set procedures to follow. This would enable the government to develop an appropriate channel to take different views and opinions, and provide a platform to debate for a best policy outcome. The set procedures would help to avoid any arbitrary decisions;
- Industry and stake holders should approach policymakers through official channels. It would avoid the situation where voices are conveyed through personal contacts which might produce biased personal preferences;
- In presenting the case, industry and stake holders should base their arguments more on objective and comprehensive market research to best reflect their interests rather

than be simply responding to the central government's call. This could avoid the unnecessary waste of resources.

9.6 Limitation of the Micro-Macro Linkage Model when applied to China's international air transport industry

This research has employed the Micro-Macro Linkage Approach to study China's international air transport policymaking from 1978 to date. The model was first introduced by Zhao (1996) when he attempted to analyse the country's foreign policymaking from 1949 to 1996. He borrowed the concepts of macro and micro analysis from social research theory that had emerged in the 1980s and integrated them into his analysis about China's foreign policy making. He argued that the linkage of elements at different levels, whether of individuals or small-group behaviour, together with the global influence of institutions, communities, and nations, would help the researcher avoid falling into the tendencies of either excessively relying on macro-determinism or micro-determinism (Zhao, 1996). The key to the model lies in its emphasis on the linkage, namely on the movement and mutual influence of these factors.

To further explain how the movement and interaction of the factors at different levels work with each other, Zhao (1996) brought in Giesen's (1987) Evolution-theoretical Model and incorporated it into his own formula, which divided social reality (macro structure) into three dimensions: symbolic macrostructure, institutional macrostructure and power/regime macrostructure. In weaving together these two models, he created a framework (refer to Chapter 8) and applied it to analysing China's foreign policymaking between 1949 and 1996, as well as a case study on Japan's ODA to China.

Based on Zhao's combined Model, this researcher has also developed a framework, incorporating the elements of the features of the air transport industry (refer to chapter 8) and applied it to analysing China's policymaking in three country-pair markets. The framework has enabled the author to achieve the objectives set out in this thesis, however, there are some limitations which refrained the researcher from investigating further the policymaking process.

First, the model directs the researcher to focus exclusively on how the factors at the macro level have an impact on ideological change at the micro level. In his elaboration about the symbolic macrostructure, Zhao did not identify international organisations, laws, regimes and regulations as sources of influence, nor did he try to explain how China dealt with international organisations, nor whether the country internalised any international laws and conventions which affected its political and economic system and reality. It is not deniable that perceptions and ideas held by policy makers really matter on policy change, because they help policy makers and other players identify and interpret the nature of external change (Aggarwal and Lee, 2011). However, it is similarly critical to explain explicitly how international circumstances have worked to shape the ideas and opinions.

A second limitation is that he did not explain how domestic factors were reacting to the international environment, which exerts an impact on the policymaking process. In examining domestic situations, he borrowed Putman's (1988) two-game theory to discuss how winning sets were achieved. However, he did not explain who were involved in that game and how these participants, namely elites, bureaucrats, foreign counterparts, interest groups and other stakeholders, bargained with each other to enable the negotiators to obtain the trade-offs accepted by all.

Thirdly, he introduced quite a few concepts by borrowing elements of other models to his framework, which made it complicated to understand and apply for empirical study. By pulling these concepts together, he failed to identify any particular variables at both the macro and micro levels and examine how these variables interact with each other and how these variables acted as a cause leading to the policy formation and change. Instead, he concentrated on explaining what the decision-makers' perception of the situations were and what their policy statements were. Such a description could not convince the reader to establish the causal link between the situation and the policy outcome.

The model was intended to cover various dimensions of the policymaking process. However, when applied to the case study, he failed to address the relationships between the international and domestic levels to analyse how the international environment, both

globally, regionally and bilaterally have affected the domestic policymaking. He did not explain what the global situation was like, how the situation affected the domestic situation in both China and Japan but only briefly discussed the pressure faced by both countries from the US and the rest of world. Nor did he discuss how exactly global pressure caused policy changes in both China and Japan.

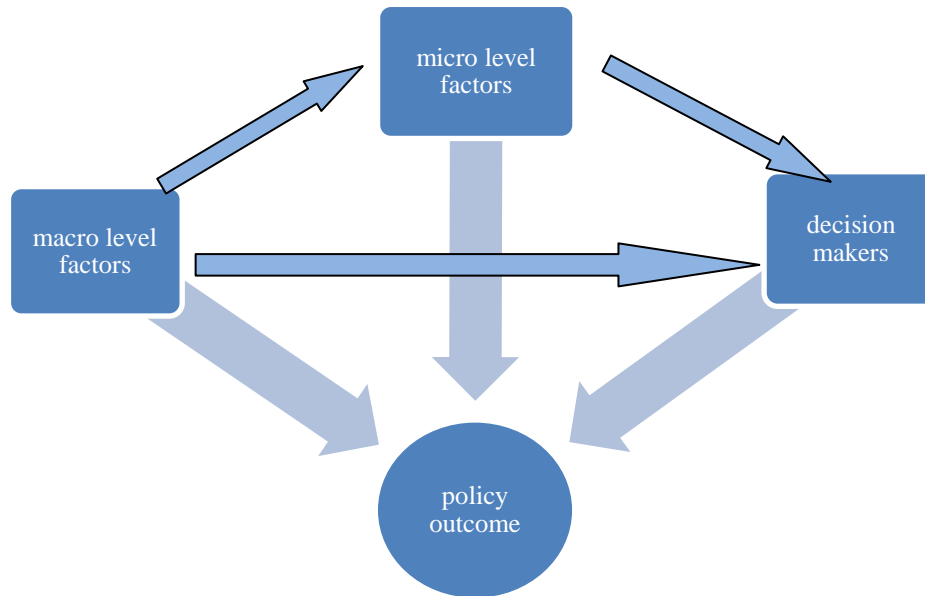
9.7 A revised model

It is widely accepted that foreign trade policy results from the constant interaction of international and domestic forces. Over the years, various schools have developed various theories, models, approaches and frameworks, all with an attempt of determining how these forces interact with each other and which of them hold a greater weight. Tremendous efforts have been made with a substantial amount of empirical studies conducted, though the issue has remained to be resolved (Lai, 2010).

While recognizing the progress made, it is noticeable that existing literature still suffers from a remarkable lack of an analytical framework which is theoretically rigorous to account for both internal and external origins of trade policymaking in China (Lai, 2010). It is for this reason that some scholars called for the need for a theoretically sophisticated and empirically grounded re-examination of the studies on the subject matter so as to enhance it to a more advanced level. Nevertheless, numerous research has been undertaken exploring the interaction of international and domestic factors and the findings have shed light on how these factors have evolved over the decades and how they have impacted on the policymaking process.

With the above limitations, this author suggests a revised model as follows (Figure 9.3):

Figure 9.3 Revised Macro-Micro Linkage Model.



Macro level factors refer to the environment at international, regional and bilateral levels. They include international regime, international law, international organisations, regional cooperation bodies, political and economic forums, and bilateral relations that are out of control of the sovereign state. They have a direct impact on micro level factors as well as on individual decision makers. Identically, micro level factors indicate the sources at the domestic level which include the state government, its national policy, interest groups, media, public opinions, think tanks and institutions that are operating within the boundary of a nation state. They, too, have a direct impact on the individual decision makers and the policy outcome. Factors at these levels together exert an influence on the final policy outcome, though the weight of the factors at each level might be different.

9.8 Challenges ahead

It has been more than 30 years since the US first deregulated its domestic air transport market. The spill-over effects have spread rapidly, causing other countries around the world to follow suit. Liberalising the international air transport market has been a major theme over the last two decades, with the EU-US Open Skies arrangements being a milestone in lifting the economic constraints of airline operations across borders. On the other hand, Open Skies agreements still only go part way to normalizing the industry, as they continue to restrict access to domestic markets and leave ownership and control rules untouched (UK CAA, 2006). Hence, creating an OAA³¹ becomes an ultimate objective of the policymakers so that not only restrictions on trade barriers such as market entry and capacity are removed but also the limitations on control and ownership of national airlines are relaxed so as to allow airlines to optimize the opportunities in global capital markets and to have access to the domestic markets of other countries.

According to Forsyth et al (2004), the primary rationale for Open Skies is economics. When implemented effectively and works as intended, Open Skies will produce comprehensive net economic benefits for the countries participating in the arrangement (Forsyth et al, 2004). For example, IntraVISTAS-ga2 report in 2006 found that liberalization of bilateral air transport relations can have an enormous and positive impact on regional prosperity. Traffic growth subsequent to Open Skies typically averaged between 12 and 35 percent, with some growth exceeding 50 percent. For individual countries, Open Skies means overall economic benefits such as generating more job opportunities and contributing to their GDP growth. For the aviation industry, airlines are able to enjoy more flexibility to develop their routes and networks as they choose, giving passengers more options for flights with lower fares. While at the same time, Open Skies can also have an adverse impact on the airline industry with fierce competition, which might result in long established yet inefficient national airlines being bankrupt. National governments, while appreciating the gains in economic terms, are also concerned with non-economic objectives, such as national defence and security, being adversely affected (Forsyth et al, 2004). Although it is becoming apparent that

³¹ An OAA already exists within the 27 Member States of the EU as a result of the creation of a European Single Market and between Australia and New Zealand.

governments are increasingly willing to relax controls over route entry and pricing, they are less willing to agree to anything that implies the surrender, or even partial surrender, of their sovereignty in the matter of traffic rights (Hanlon, 2007), which lies in the core of Chicago Convention. With this paradox being the biggest conflict of all, individual governments can be reluctant to make the move towards full Open Skies. Agreements become so difficult to achieve, especially between nations unless they are like-minded and share the belief that more open markets would serve consumers better and improve the prosperity of society as a whole regardless of the performance of individual airlines.

Notwithstanding this, the arguments for and against liberalization have never ceased. Those who have voiced for full and complete liberalization are able to cite numerous empirical studies on the impact of liberalization highlighting the benefits for industry, consumers and society, while those who have argued for re-regulation are mainly concerned about the safety implications and the poor financial performance of the industry, citing the inconsistency of various regulatory regimes that might lead to free-riders, thus raising strong commercial, strategic and presentational concerns about the fairness of allowing ownership of domestic airlines by nationals from countries which do not have broadly equivalent open investment rules (UK CAA, 2006). One of the key challenges is how the complex framework of inter-dependent bilaterals might be unwound while maintaining effective regulatory control over safety (UKCAA, 2006). Another challenge is how to address the issue of regulatory divergence, namely the distortionary impact of different regulatory approaches applying to competitors operating in the same market, thus a regulatory convergence is required to accommodate the differences so as to allow fair competition (UK CAA, 2006).

Over the last three decades, China's air transport industry has enjoyed an explosive growth at an average of 9 percent per annum from a smaller base than traffic in North America (Hanlon, 2007). Ironically, this phenomenal achievement has been made in the course of the country's regulatory reform, which is still half way to go for a full liberalisation, both domestically and internationally. With its huge population and latent demand, the Chinese market is set to become one of the biggest in the years to come (Hanlon, 2007). With liberalisation being an irreversible trend all over the world, China will no doubt follow this course. Its approach towards liberalisation, its policies and

measures taken in opening up its markets will not only affect itself, its peripheral neighbours in the region, its trade partners but also the rest of the world. National interest is an overwhelming consideration while at the same time economic prosperity and social benefits is also a primary concern. How China addresses the issue of liberalising the market while at the same time maintaining a sustainable growth will be crucial for its long-term prosperity. There still is a long way to go.

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APPENDICES

Appendix A Interview questions for Mr. Klaus Geil, Air Transport, Internal Market, Air Transport Agreement & Multilateral Relations, the EU. The interview was done on 6th April 2010 in his office in Brussels.

1. How do you see the development of bilateral relations with respect to air transport between China and the EU?
2. Is China important to the EU in terms of air transport industry, in which way and why?
3. Over the past two decades, when was the biggest breakthrough and what was it and how significant this breakthrough was?
4. What does the EU want to achieve in the next 2 to 5 years?
5. What are the main objectives for the EU carriers in Chinese market?
6. What impact does it have on other Asian countries and the rest of the world in terms of Sino-EU bilateral air transport relations?
7. When was the most difficult period of time in bilateral relations?
8. How many rounds of discussions has EU had with China,
9. What is the agenda like for each round?
10. What are the main objectives you want to achieve for each round of discussion
11. How do you formulate/amend the agenda before/during the discussions
12. What you have achieved against the objectives set in the agenda
13. What are the main issues that both parties could not agree on to achieve all objectives in the agenda
14. To what extent Netherlands needs to discuss with EU in terms of air transport negotiation
15. What are the issues that EU are most concerned, and what is yours,
16. How do you see the approaches of Chinese delegation
17. Which person as chief negotiator achieved most and whom is his counterpart in China?
18. What is your next step?
19. What is your expectation for the next round of discussion?
20. How do you see the relationship between EU and China?

21. Any conflicts of interest? If so, how do you address them?

22. How do you see the relationship between China and USA, and EU and USA.

Appendix B Interview questions for Mr. Alphons Daniels, Chief Negotiator Air Service Agreement, Ministry of Environment and Infrastructure of the Netherlands. Interview was done through emails in June 2010.

1. How do you see the development of bilateral relations with respect to air transport between China and the Netherlands/EU?
2. Is China important to the Netherlands in terms of air transport industry, in which way and why?
3. Over the past two decades, when was the biggest breakthrough, what was it and how significant this breakthrough was?
4. What are the key issues between China and the Netherlands in terms of bilateral air transport arrangements?
5. What does the Netherlands want to achieve in the next 2 to 5 years?
6. What are the main objectives for the Netherlands carriers in Chinese market?
7. What impact does it have on other Asian countries and the rest of the world in terms of Sino-Netherlands bilateral air transport relations?
8. How many rounds of discussions have Netherlands had with China,
9. What is the agenda like for each round?
10. What are the main objectives you want to achieve for each round of discussion
11. How do you formulate/amend the agenda before/during the discussions
12. What you have achieved against the objectives set in the agenda
13. What are the main issues that both parties could not agree on to achieve all objectives in the agenda
14. To what extent do you involve KLM and Amsterdam airport in your preparation for the bilateral negotiations?
15. How do you communicate with KLM and Amsterdam?
16. To what extent Netherlands needs to discuss with EU in terms of air transport negotiation
17. What are the issues that EU are most concerned, and what is yours,
18. How do you see the approaches of Chinese delegation
19. Which person as chief negotiator achieved most and whom is his counterpart in China?
20. What is your expectation for the next round of discussion

21. How do you see the relationship between EU and China, and Netherlands with China
22. How do you address issues that you are most concerned
23. How do you see the relationship between China and USA, and Netherlands and EU

Appendix C Interview questions for Mr. Wilco Sweijen, Director Aviation marketing, and Mr. Bart Pouwels, Director Business Development Cargo, Amsterdam Airport. Interview was done on 1st July 2010 in their office at Amsterdam Airport.

1. How do you see the development of bilateral relations with respect to air transport between China and the Netherlands/EU?
2. Is China important to Amsterdam airport , why?
3. What are the key issues between China and the Netherlands in terms of bilateral air transport arrangements, from airport's perspective?
4. What does the Netherlands/AMS want to achieve in the next 2 to 5 years?
5. How many rounds of discussions have the Netherlands had with China,
6. How many has AMS participated?, Why you want to be involved? Are you invited or requested? When did you start to join the discussions?
7. what are the main objectives you want to achieve for each round of discussion
8. What are your main concerns of each round of discussions?
9. What is your main concern/objective for this one?
10. How do you coordinate with your government before, during and after each round of discussions?
11. Do you speak to your government directly, or through other agencies, or people, or organization?
12. How do you communicate with them, email, face to face meeting, or all that is necessary
13. How do you evaluate their support? Successful, effective, achieved your objective and got what you want? Or not ideal?
14. How do you see the discussion with the Chinese counterparts? Are they hard negotiators? Are they flexible in their negotiation?
15. Do you talk to Chinese airlines or airports directly?
16. Do you speak to other Chinese organizations directly?
17. Who is speaking to them directly?
18. What are your key messages
19. what do you want to achieve by speaking to them directly?
20. How effective it is for you to speak to them directly?

21. How do you see the future?

Appendix D Interview questions for Mr. Rowland van Klaveren, Director Government & Industry Affairs, KLM. Interview was done on 1st July 2010 in an office of Amsterdam Airport.

1. How do you see the development of bilateral relations with respect to air transport between China and the Netherlands/EU?
2. Is China important to KLM , why?
3. What are the key issues between China and the Netherlands in terms of bilateral air transport arrangements, from airport's perspective?
4. What does the Netherlands/KLM want to achieve in the next 2 to 5 years?
5. How many rounds of discussions have the Netherlands had with China,
6. How many has KLM participated?, Why you want to be involved? Are you invited or requested? When did you start to join the discussions?
7. What are the main objectives you want to achieve for each round of discussion
8. What are your main concerns of each round of discussions?
9. What is your main concern/objective for this one?
10. How do you coordinate with your government before, during and after each round of discussions?
11. Do you speak to your government directly, or through other agencies, or people, or organization?
12. How do you communicate with them, email, face to face meeting, or all that is necessary
13. How do you evaluate their support? Successful, effective, achieved your objective and got what you want? Or not ideal?
14. How do you see the discussion with the Chinese counterparts? Are they hard negotiators? Are they flexible in their negotiation?
15. Do you talk to Chinese airlines or airports directly?
16. Do you speak to other Chinese organizations directly?
17. Who is speaking to them directly
18. What do you want to achieve by talking to Chinese organization directly?
19. What are your key messages?
20. How effective it is for you to speak to them directly?
21. How do you see the future?

Appendix E Interview questions for Prof. drs. J. G. de Wit, Director of Airneth and Prof. Dr. Pablo M. de Leon of University of Leiden. Interviews were done on 2nd July 2010 in the Hague, the Netherlands.

1. How do you see the development of bilateral relations with respect to air transport between China and the Netherlands/EU?
2. Over the past two decades, when was the biggest breakthrough, what was it and how significant this breakthrough was?
3. What are the key issues between China and the Netherlands in terms of bilateral air transport arrangements?
4. What impact does it have on other Asian countries and the rest of the world in terms of Sino-Netherlands bilateral air transport relations?
5. How does your government involve stakeholders in their policymaking process
6. How does it communicate with the stakeholders?
7. To what extent Netherlands needs to discuss with EU in terms of air transport negotiation
8. What are the issues that EU is most concerned, and what is the Netherlands'?
9. How do you see the relationship between EU and China, and Netherlands with China
10. How do you address issues that you are most concerned
11. How do you see the relationship between China and USA, and Netherlands and EU

Appendix F Interview questions for Mr. Simon Knight, Head of Negotiations for CIS, Asia-Pacific and North America, International Aviation and Safety Division, Department for Transport of the UK. Interview was done via telephone on 2nd December 2010 in the UK.

1. To my knowledge, there have been ten rounds of discussions between the UK and China, what are the main objectives you want to achieve for each round of discussion
2. How do you formulate/amend the agenda before/during the discussions
3. What you have achieved against the objectives set in the agenda
4. What are the main issues that both parties could not agree on to achieve all objectives in the agenda
5. To what extent do you involve airlines and airports in your preparation for the bilateral negotiations?
6. How do you communicate with airlines and airports ?
7. 85, 90, 91 and 94 negotiations, little documented from Chinese side. What are the main topics of these negotiations, and what had been achieved respectively?
8. When Hong Kong started to allow Chinese carriers to operate and what was the agreement like, and when the agreement was reached,
9. To what extent UK needs to discuss with EU in terms of air transport negotiation
10. What are the issues that EU are most concerned, and what is yours
11. How do you see the approaches of Chinese delegation
12. What is your expectation for the next round of discussion
13. How do you see the relationship between EU and China, and UK with China
14. How do you see the relationship between China and USA, and UK and EU

Appendix G Interview questions for Mrs. Carol Cole, General Manager International Relations of British Airways. Interview was done via telephone on 23rd December 2010 in the UK.

1. Is China important to BA, why?
2. What does BA want to achieve in the next 2 to 5 years?
3. What are the key issues between China and the UK in terms of bilateral air transport arrangements, from BA's perspective?
4. How many rounds of discussions has the UK had with China and how many has BA participated?
5. What are the main objectives you want to achieve for each round of discussion, and how do you evaluate your achievements?
6. What are your main concerns of each round of discussions? Have you been able to address the concerns and achieve your objectives?
7. Is BA interested in expanding into secondary airports in China, in addition to the current two gateways? And Why?
8. Why BA wanted to fly to Shanghai? Did BA request to fly to Shanghai in 1998 before the agreement reached, or asked for the right after the 1998 agreement?
9. BA failed to be granted access to Shanghai in 1999. What did BA do to eventually secure the right to Shanghai subsequently?
10. Is BA happy about the current arrangements, or do you think it should be more liberalized in terms of capacity, designation, traffic rights, and cargo operation?
11. How do you coordinate with your government before, during and after each round of discussions? How do you communicate with them,
12. How do you evaluate government's support? Successful, effective, achieved your objective and got what you want? Or not ideal?
13. Do you speak to Chinese government too?
14. Do you talk to Chinese airlines or airports directly?
15. What do you want to achieve by talking to Chinese directly?
16. How effective it is for you to speak to them directly?
17. How do you see the future?

Appendix H Interview questions for Dr. Barry Humphreys, Former Head of Government and International Affairs of Virgin Atlantic. Interview was done via telephone on 5th December 2010 in the UK.

1. Is China important to Virgin, why?
2. What does Virgin want to achieve in the next 2 to 5 years?
3. What are the key issues between China and the UK in terms of bilateral air transport arrangements, from Virgin's perspective?
4. How many rounds of discussions has the UK had with China and how many has Virgin participated?
5. What are the main objectives you want to achieve for each round of discussion, and how do you evaluate your achievements?
6. What are your main concerns of each round of discussions? Have you been able to address the concerns and achieve your objectives?
7. Is Virgin interested in expanding into other gateways as well as secondary airports in China, in addition to Shanghai? And Why?
8. Did Virgin ask for Shanghai before 1998 discussion, or only require the traffic right after the agreement was reached in 1998? Why Virgin wanted to fly to Shanghai rather than Beijing?
9. When Virgin was first granted access to Shanghai in 1999, what was the argument, and how did you convince the government to secure the traffic rights and the route license?
10. How do you coordinate with your government before, during and after each round of discussions? How do you communicate with them,
11. How do you evaluate government's support? Successful, effective, achieved your objective and got what you want? Or not ideal?
12. Do you speak to Chinese government too?
13. Do you talk to Chinese airlines or airports directly?
14. What do you want to achieve by talking to Chinese directly?
15. How effective it is for you to speak to them directly?
16. How do you see the future?

Appendix I Interview questions for Mr. Thomas S. Engle and Mr. Adam Packer of the Department of State of the US. Interview was done via emails on 11th January 2011.

General information:

1. The Office of Aviation Negotiations (AN) within EEB/TRA within DOS is responsible for developing Open Skies strategies and leads the negotiation. Is this the correct information?
2. How does the Office of Aviation Negotiations (AN) coordinates with the Office of Transportation Policy (OTP), and whether this OTP is involved in any negotiations?
3. What is the relationship between DOS and DOT? And how do you coordinate with DOT before, during or after the negotiations?
4. Which division formulates the agenda for each round of negotiation?

For 2004 and 2007 protocol:

5. For the negotiations held in 2004, which division formulated the agenda for the US side
6. What was your agenda like, and how do you amend it during the negotiations?
7. What were your expectations for the outcome of the 2004 negotiations, as there had been no discussions between the US and China since 1998, almost 6 years in between?
8. What you have achieved against the objectives set in the agenda ?
9. Why did 2004 negotiations so difficult to reach an agreement (seems that you have held several round of discussions starting from 2003 before the protocol was signed)?
10. What were the main issues that both parties could not agree on to achieve all objectives in the agenda
11. After the 2004 protocol, your airlines implemented the arrangements quickly with significant achievements. Was that what you had anticipated?
12. How did you evaluate the market to justify your agenda and objectives that you wanted to achieve?
13. To what extent do you engage the industry/community stakeholders to the

negotiation?

14. How do you consult with airlines, airport, and industry associations to formulate your negotiation strategies?
15. How did you balance their requests?
16. Why did you involve the industry association such as pilot's in the bilateral negotiation?

For 2007 protocol:

17. What were your considerations for 2007 negotiations?
18. What was your agenda and objective for 2007 negotiation?
19. What were the main issues that both parties could not agree on and how you compromise that for the benefits of an agreement?

For the next round of discussion:

20. The 2007 protocol said that both parties would resume discussions no later than March 2010, have you started the discussion yet?
21. What was your timescale like in terms of agreeing an overall Open Skies deal? In how many years do you anticipate China will be ready / or you think China is ready already for the deal?
22. What you have achieved against your objectives?
23. What are your expectations?

Regarding Sino-US air transport market:

24. How important is the air transport market between China and the US from the US perspective? In which way and how do you measure it?
25. How do you compare the country-pair market with that between Japan-US, and Korea-US?

Appendix J Interview questions for the former senior official of the US Embassy in Beijing. Interview was done in September 2007 in Beijing.

1. How do you see the development of bilateral relations with respect to air transport between America and China?
2. How important is it in terms of 2004 protocol and 2007 protocol?
3. Is China important to the US in terms of the air transport industry, in which way and why?
4. Over the past two decades, when was the biggest breakthrough, what was it and how significant was this breakthrough?
5. What does the US want to achieve in the next 2 to 5 years in respect of air transport links with China?
6. What are the main objectives for US carriers in the Chinese market?
7. What impacts do Sino-US bilateral air transport relations have on other Asian countries and the rest of the world?
8. Is China part of the package of arrangements between the US and ASEAN countries, or North Asian countries?
9. Why put aviation under the big umbrella of Trade?
10. When was the most difficult period of time in terms of bilateral relations between the two countries?
11. How do US-China bilateral negotiations compare with other country pair arrangements?
12. During the tenure of the Clinton and Bush administrations, what influence did diplomatic relations between the two countries have on air transport developments? What do they see the aviation relations between the two countries?
13. How about Obama? What do you see the tendency like?

Influence of airlines and airports on the US Government in choosing origin/destination/city pairs

14. When preparing bilateral negotiations, are there any airports involved in lobbying the US Government in the choice of destination cities in China?

15. What role, if any, do these airports play? Do their opinions have any impact on negotiation strategies with respect to China?
16. Which airlines do you choose to fly to China, and why do you choose these particular ones, in terms of the assessment criteria, with respect to the designated carriers, and specified routes?
17. Before designating any new carrier, what do you seek from the current carriers operating to China?
18. Are there any differences in your policy between passenger and cargo carriers?
19. Do you have in mind particular cities/points before the bilateral negotiations? Or are the cities chosen completely at the suggestion of existing and prospective carriers?
20. When you agreed that FedEx should set up a cargo/distribution hub at Shanghai, what were the factors you considered? What do you want the carrier to achieve in the short term and long term? How about UPS's hub in Guangzhou?

Appendix K Interview questions for the Chief Representative of Northwest Airlines Beijing Office. Interview was done in November 2008 in Beijing.

1. To what extent Northwest influence US government in their negotiation with China regarding aviation relations
2. Is this in the process of negotiation, or implantation? E.g. Northwest starting cargo operation, or change schedules for winter/summer season
3. How does northwest see its potential in China? which city pairs, or the whole market?
4. How Northwest has benefited from 2004 and 2007 protocols respectively?
5. Merger with continental have any impact on your operation and strategy to China?
6. How to see the competition between us carriers who are operation between the country pair, though the routing is different?
7. How competitive is Chinese carriers from Northwest perspective
8. Do airports/local authorities influence your decisions at all, or a little,
9. Are they Chinese airports, or us airports, or local authorities?
10. How important is Chinese market for Northwest airline?
11. In terms of cargo, how competitive you are compared with UPS and FedEx, who have set up their hubs in China after 2004?

Appendix L Interview questions for Mr. Genaro J. Pena, Director of Marketing, Marketing, Communications and Community Affairs of Houston airport. Interview was done via telephone on 18th June 2010.

1. How do you see the development of bilateral relations with respect to air transport between China and the USA?
2. Is China important to the USA in terms of air transport industry, in which way and why?
3. Over the past two decades, when was the biggest breakthrough, what was it and how significant this breakthrough was?
4. What are the key issues between China and the USA in terms of bilateral air transport arrangements?
5. What does USA want to achieve in the next 2 to 5 years?
6. What are the main objectives for the USA airports in Sino-US market?
7. What impact does it have on other Asian countries and the rest of the world in terms of Sino-USA bilateral air transport relations?
8. How many rounds of discussions have USA had with China,
9. How many have Houston participated ?, Why you want to be involved? Are you invited or requested? When did you start to join the discussions?
10. what are the main objectives you want to achieve for each round of discussion
11. What are your main concerns of each round of discussions?
12. What is your main concern/objective for this one?
13. How do you coordinate with DOS and DOT before, during and after each round of discussions?
14. Do you speak to DOT, DoS directly, or through other agencies, or people, or organization?
15. How do you communicate with them, email, face to face meeting, or all that is necessary
16. To what extent does the senator of Texas support you in your aviation-related issues?
17. How do you evaluate their support? Successful, effective, achieved your objective and got what you want? Or not ideal?
18. How do you see the discussion with the Chinese counterparts? Are they hard

negotiators? Are they flexible in their negotiation?

19. Do you talk to Chinese airlines or airports directly?
20. Do you speak to other Chinese organizations directly?
21. Who is speaking to them directly?
22. How effective it is for you to speak to them directly?
23. How do you see the future?

Appendix M Interview questions for Mr. Wang Yuanzheng, Senior Officer of Air Transport Bureau of ICAO. Interview was done via emails on 11th February 2011.

1. Since 2003 the 5th World air transport conference, has ICAO even issued anything, in whatever format, with respect to the liberalisation of the global air transport industry, besides the Declaration made at that Conference?
2. Is there anything (resolutions, whatever) that is mandatory for the member states who must abide by and implement in this regard?
3. Has ICAO ever requested/required its member states to liberalise its air transport market, especially the international air transport?
4. What used to be ICAO's view towards Open Skies , and how it is shaped, and how it has changed?
5. Do you see any corelationship between ICAO's action and China's liberalisation policy change?
6. Does the fact that China is a Council Member of ICAO have anything to do with China's liberalisation policy change?
7. How do you see ICAO's impact on China's liberalisation policy?
8. Why it took so long (from 1994's 4th conference to 2003's 5th conference, almost 8 years in between) for ICAO to convene the conference with a declaration made?
9. CAAC announced its policy " to liberalise its international air transport market in an active, progressive, orderly and safeguarded manner" by Yang Yuan Yuan at the same Conference. How do you explain this in terms of timing and venue for China to announce its policy?

Appendix N Interview questions for Traffic Rights Management Office of Hainan Provincial Government. Interview was done in March 2007 in Haikou City, China.

How did you win the traffic rights?

1. How did Hainan come to the idea to have the traffic rights, did you have it yourself , or you were approached by the Central authority who has decided to make it a pilot place?
2. How did you win the traffic rights?
3. Who has been very supportive in helping Hainan to win the traffic rights? At what level are these officials? Provincial or central government, or local municipal government? Or from other areas? Are they aviation related or not?
4. Who did you influence to win the rights, in which way?—networking, lobbying, Who are involved in the process?
5. How long did it take you to win the rights? What other work have you done to convince the authority that Hainan could serve as a pilot place?

Progress made since Opening-up, investment, airline operation, routes, passenger and cargo, tourists or business travel:

6. How did you get yourself prepared during this process? Have you had investment in infrastructure—airport, access to airport such as highway or express way, more hotels, leisure facilities as holiday destinations?
7. How big the investment is and how did you finance it?
8. What benefits have these investments brought to you in terms of rate of capital return, utilisation, public benefits, such as lower fares, more flights available and more destinations available?
9. How many more airlines have started their operation to Hainan, who are they? How many new routes have been started since then?
10. What do these airlines say about operating to Hainan in terms of their traffic --- passenger demand, inbound and outbound traffic, business and leisure passengers, cargo?
11. What is the increase rate of passenger travel and cargo transport?
12. How about the foreign tourism boost, how many international tourists have come to

- Hainan, and how many it was before the traffic rights were granted, what is the increase rate? What are the passengers like in terms of their nationality, Are they American, or from other countries? Do you have statistics and analysis?
13. What is the forecast before Traffic rights were granted? How big the difference/gap is?
 14. If there is a big gap between the forecast and the realised passenger volume, have you done anything to boost the passenger demand, and how did you do it? What are the results? Any figures and data and statistics to show and to support this?
 15. Has the Opening-up in Hainan brought any foreign investment as a direct result? What kind of investment it is? Any joint –ventured manufacturing facilities, or sole foreign investment? How is the operation? Have they employed any local labour and how many local labours working in these organisations?
 16. What is the economic growth rate since the traffic rights were granted, how big is the difference between the current economic growth rate and the previous rate?
 17. Why you decided to subsidize for the airlines?
 18. How much has Hainan authority subsidised to those airlines? Is the subsidisation rate applicable to all airlines—both foreign and local airlines, including Hainan airlines?
 19. In Europe, the practice is to subsidize the airlines via airports in their commercial arrangements in order to boost the market, do you think that there is any sign of moving towards that way so as to get government less involved in market operation?

Airline competition, productivity, labour cost, market share, management issues

20. Has Hainan airline faced more severe competition from foreign airlines, and what do you think Hainan's position is in this market, very competitive, stronger than before, or else?, compared with both China Southern's Hainan Branch, and other foreign carriers?
21. Where do you position yourself in Chinese market, are you a network airline, or a network with new business model?
22. You have ordered more—about 100 regional jets, where do you want to put them into, in which market?
23. What are the biggest challenges Hainan Airline is facing since the Opening-up in

terms of strategy and operation, human resources, facility, service level?

24. What are the biggest changes of your strategy and objectives? What are your strategies and vision now?
25. What are the new routes Hainan Airline has opened since then? And Where they go?
26. What is the market share now for Hainan compared with other airlines, especially on Sino-US routes?
27. How about the fares on these international routes, to what extent have they decreased, the percentage?

Airports:

28. How many passengers have travelled through Haikou airport, Who are they? Are they business or leisure passengers, are they international inbound tourists or domestic outbound travellers?
29. How big the increase is, the annual increase rate? Which type of passengers has a greater increase rate, international inbound or domestic outbound?
30. How about cargo?
31. What has airport done to help promote Hainan as an opening-up destination?
32. New investment in facilities, marketing campaigns, people training?

Traffic rights Office:

33. When did you set up this office? Why? What are the main responsibilities?
34. What progress you have made in pushing forward the Opening-up?
35. What contributions do you think this Opening-up has made to Hainan's economy?
More employment, more inbound tourists and outbound tourists, more business travellers in and out, more foreign direct investment, improved service level and gaining management experience?
36. Is there any improvement you would like to have? Any adverse/negative effects?

Appendix O Interview questions for Mr. Li Jiangmin, Director General and Ms. Liang Nan, Director, Department of International Affairs and Cooperation of CAAC. Interviews were done in their office in June 2009 and October 2010 in Beijing.

1. When did you start the work in bilateral negotiations?
2. How do you like it?
3. What are the biggest challenges?
4. How do you address the carriers' needs and wants?
5. How much research do you conduct? By your staff or report from the carriers and airports?
6. To what extent have you achieved from carriers perspective?
7. To what extent have you achieved from airports perspective?
8. How do you evaluate the negotiation results, by carriers' operational results or something else? i.e. local economic development, international trade, and export, people movement, outbound and inbound tourists?
9. How much attention do you give to local government's requirements and needs?
10. Why do you choose Hainan as your pilot point of call for fifth/sixth/seventh traffic rights? What are your considerations?
11. When you decided to choose Hainan as pilot point of call, who talked to you most, Hainan Airline, or Hainan provincial government, or the airport?
12. What benefits have the policy brought to the islands?
13. How do you want you continue? In which way?
14. Following that, we do see more cities chosen to be given more freedom of traffic rights, including Nanjing, Wuhan, etc, what are your considerations when selecting these cities/airports?
15. Why China give African countries special treatment y allowing them more traffic rights?
16. When carriers are crying for losses and non-profitability, and losing the competition, how do you listen to their voices?
17. Who/which party is more influential in your decision-making as to multi-designation, and no limitation on capacity?
18. The biggest breakthrough came last May during the visit of Madam Wu Yi, how do

you comments on that?

19. The fiercest criticism came from local carriers who voiced against the arrangement which was reached between C and US in the year 2003/2004, how do you see this?
20. Are you a protectionist, guard the interests of local carriers and organizations, or are you a pro-reformist? Open up first and then learn to compete?
21. Do you have any formula or evaluation process with respect to your –liberalisation policy?
22. How long does it take you before one policy is announced to be implemented?
23. Both EU and USA are very demanding before any bilateral negotiations. How do you view that? They make a lot of comments on the current situation, and would envisage the future and prospective development provided any arrangement is agreed, how do you address this?
24. When do you think you face the biggest pressure from EU itself, or from central government? Or from local government and local carriers and airports?
25. How do you address the requirements from local CPPCC representatives? They usually have quite some proposals every year at their annual congress, which are forwarded to your department and/or others.
26. To what extent do you take their requirements and requests into your considerations in deciding your negotiating strategy, and taking their city/airport as an origin/destination?
27. From one to one, to one to a group, how do you consider the EU strategy as a whole?
28. EU has requested quite a few meetings for further negotiation, and still both have not achieved much, why is that?
29. Before 1998, not much done, how do you evaluate that?
30. Before you, Lu and Zhang quite rigid in bilateral arrangement, how do you comment on that?
31. Do you believe that aviation policy is support the travel industry?
32. How many flights have been increased since the Visa arrangement has been agreed?
33. How many more inbound and outbound passengers?
34. China and South Korea, more capacity allowed almost at the very beginning of the bilateral aviation relationship, why is that?

35. Which city pair has the most frequent flights? Are they in Shandong province, or elsewhere? How does the province convince you that they need more flights to feed the market?
36. Korean Air is also allowed to have stake in Okay Airline?

Appendix P Interview questions for China Southern Airlines (Interviewee prefers to remain unanimous). Interview was done via telephone in December 2010.

There have been 5 bilateral negotiations between China and the Netherlands, with China Southern being involved in each discussion.

1. For each round of discussions held in 1996, 1998, 2003, 2006 and 2010, what are the requirements of China Southern, and what are your main considerations when putting forward your requirements, is that based on your performance or the market situation?
2. What do you see the outcome of the negotiations, is there a gap between the actual result and your expectation? Has it satisfied your requirements, and in what way?
3. How do you implement the negotiation results, immediately to increase the capacity or after a while?
4. How do you communicate with CAAC, other stakeholders and how effective the communication is?
5. Do you have any direct contacts with the Netherlands government? Do you raise any issues with respect to your operation into their country?
6. In terms of cargo, how has been your collaboration with Martinair
7. In terms of passenger operations, how do you see your competition with KLM, from what perspective do you see the competition or collaboration?

Regarding the China-US market,

1. How do you see your operations in the Sino-US market, compared with other Chinese carriers?
2. What were your considerations when you first requested to operate to the US in late 1990s?
3. How do you voice your views about your international operations to Chinese government?
4. To what extent do you think that the Chinese government has taken into account your considerations when negotiating the air transport arrangements?
5. Do you coordinate with other Chinese airlines before expressing your views?
6. Do you talk to airports, local governments before talking to the Chinese government about air transport arrangements
7. How did you see the 2004 and 2007 protocols reached and what impact has it have on your operations?
8. Do you talk to foreign governments/airlines/airports directly and how do you see your communication?

Appendix Q Interview questions for other Chinese airlines and airports including Air China, China Eastern, Beijing Capital International Airport, and Guangzhou Baiyun International Airports. (Interviewees prefer to remain anonymous). Interviews were conducted in Beijing, Shanghai and Guangzhou in September 2010.

1. How do you see your operations in the Sino-US/UK market, compared with other Chinese carriers?
2. What were your considerations when you first requested to operate to the US/UK in 1990s?
3. How do you voice your views about your international operations to Chinese government?
4. To what extent do you think that the Chinese government has taken into account your considerations when negotiating the air transport arrangements?
5. Do you coordinate with other Chinese airlines before expressing your views?
6. Do you talk to airports, local governments before talking to the Chinese government about air transport arrangements
7. How did you see the 2004 and 2007 protocols with respect to the US, and the arrangements with the UK government, and what impact has it have on your operations?
8. Do you talk to foreign governments/airlines/airports directly and how do you see your communication?